SUPREME COURT OF THE UNITED STATES

OCTOBER TERM, 1933

No. 33

THOMAS H. WELCH, PETITIONER,

vs.

COMMISSIONER OF INTERNAL REVENUE

ON WRIT OF CERTIORARI TO THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE EIGHTH CIRCUIT

INDEX

	Original	Print
Proceedings in United States circuit court of appeals, eighth circuit	a	1
Caption.....(omitted in printing)	a	
Proceedings before United States Board of Tax Appeals	1	1
Docket entries in cause No. 40852	1	1
Docket entries in cause No. 51929	2	2
Docket entries in cause No. 53119	3	3
Petition of Thomas H. Welch in cause No. 40852	4	4
Exhibit "A"—Notice to Thomas H. Welch of deficiency in tax, August 2, 1928	6	5
Answer of Commissioner of Internal Revenue in cause No. 40852	7	7
Petition of Thomas H. Welch in cause No. 51929	8	7
Exhibit "A"—Notice to Thomas H. Welch of deficiency in tax, November 13, 1930	10	8
Answer of Commissioner of Internal Revenue in cause No. 51929	14	12
Petition of Thomas H. Welch in cause No. 53119	14	13
Exhibit "A"—Notice to Thomas H. Welch of deficiency in tax, January 13, 1931	16	14
Answer of Commissioner of Internal Revenue in cause No. 53119	21	18
Findings of fact and opinion, Lansdon, M	21	19
Order of redetermination in cause No. 40852	24	22

JUDD & DETWEILER (INC.), PRINTERS, WASHINGTON, D. C., JUNE 8, 1933

	Original	Print
Order of redetermination in cause No. 51929	24	22
Order of redetermination in cause No. 53119	25	23
Petition of Thomas H. Welch for review of decision of United States Board of Tax Appeals	25	23
Assignment of errors	28	26
Notice of petition for review and admission of service	29	27
Statement of evidence	30	28
Caption	30	28
Testimony for petitioner	30	28
Testimony of Thomas H. Welch	30	28
Stipulation of counsel approving statement of evidence	34	32
Approval of statement of evidence by member of United States Board of Tax Appeals	35	32
Præcipe for transcript	35	33
Clerk's certificate to transcript (omitted in printing)	36	
Appearances of counsel (" " ")	36a	
Argument and submission (" " ")	37	
Opinion, Stone, J	38	34
Decree	41	36
Petition for stay of mandate	42	36
Exhibit "A"—Bond (omitted in printing)	43	
Order staying issuance of mandate	49	37
Clerk's certificate (omitted in printing)	51	
Order allowing certiorari	52	38

[fols. a-d] [Caption omitted]

[fol. 1]

BEFORE UNITED STATES BOARD OF TAX APPEALS

Docket No. 40852

THOMAS H. WELCH, Petitioner,

vs.

COMMISSIONER OF INTERNAL REVENUE, Respondent

Appearances:

For Taxpayer: P. J. Coffey, Esq., A. E. Horn, Esq.
For Comm'r: C. H. Curl, Esq.

DOCKET ENTRIES

1928.

Oct. 1. Petition received and filed. Taxpayer notified. (Fee paid.)
" 2. Copy of petition served on General Counsel.
Nov. 24. Answer filed by General Counsel.
" 27. Copy of answer served on taxpayer. General Calendar.

1929.

Oct. 3. Motion for circuit calendar for hearing at St. Paul, Minn., filed by taxpayer.
" 4. Motion granted.

1931.

Jun. 5. Hearing set July 14, 1931, St. Paul, Minn.
" 26. Motion to consolidate with 53119 for hearing 7/14/31 at St. Paul, filed by taxpayer.
Jul. 15. Hearing had before Mr. Lansdon, Div. 8 on merits. Briefs due in 60 days.
" 31. Transcript of hearing July 15, 1931, filed.
Aug. 8. Brief filed by taxpayer.
" 15. Brief filed by General Counsel.

[fol. 2]

1932.

Jan. 8. Findings of fact and opinion rendered, Judge Lansdon, Div. 8. Judgment will be entered for the Commissioner.
" 9. Decision entered, Div. 8.

1932.

Jun. 21. Supersedeas bond in the amount of $8,500.00 approved and ordered filed.
" 21. Petition for review to U. S. Circuit Court of Appeals (8) with assignments of error, filed by taxpayer.
Jul. 5. Proof of service filed.
Aug. 6. Agreed statement of evidence lodged.
" 6. Praecipe filed—affidavit of service thereon.
" 9. Agreed statement of evidence approved and ordered filed.

Before United States Board of Tax Appeals

Docket No. 5129

Thomas H. Welch, Petitioner,

vs.

Commissioner of Internal Revenue, Respondent

Appearances:

For Taxpayer: P. J. Coffey, Esq., A. E. Horn, Esq.
For Comm'r: C. H. Curl, Esq.

Docket Entries

1931.

Jan. 12. Petition received and filed. Taxpayer notified. (Fee paid.)
" 12. Copy of petition served on General Counsel.
Feb. 5. Answer filed by General Counsel.
" 10. Copy served—assigned General Calendar.
Jul. 15. Hearing had before W. C. Lansdon, Div. 8 on merits. Briefs due in 60 days.
" 31. Transcript of hearing of July 15, 1931 filed.
Aug. 8. Brief filed by taxpayer.
" 15. Brief filed by General Counsel.

[fol. 3]

1932.

Jan. 8. Findings of fact and opinion rendered, W. C. Lansdon, Div. 8. Decision will be entered for respondent.
" 9. Decision entered, W. C. Lansdon, Div. 8.

1932.

Jun. 21. Supersedeas bond in the amount of $8,500.00 approved and ordered filed.
" 21. Petition for review to U. S. Circuit Court of Appeals (8) with assignments of error, filed by taxpayer.
Jul. 5. Proof of service filed.
Aug. 6. Praecipe with affidavit of service attached, filed.
" 6. Agreed statement of evidence lodged.
" 8. Agreed statement of evidence approved and ordered filed.

BEFORE UNITED STATES BOARD OF TAX APPEALS

Docket No. 53119

THOMAS H. WELCH, Petitioner,

vs.

COMMISSIONER OF INTERNAL REVENUE, Respondent

Appearances:

For Taxpayer: P. J. Coffey, Esq., A. E. Horn, Esq.
For Comm'r: C. H. Curl, Esq.

DOCKET ENTRIES

1931.

Feb. 24. Petition received and filed. Taxpayer notified. (Fee paid.)
" 24. Copy of petition served on General Counsel.
Mar. 13. Answer filed by General Counsel.
" 17. Copy of answer served on taxpayer. General Calendar.
Jun. 26. Motion to consolidate with docket 40852 for hearing in St. Paul, July 14, 1931, filed by taxpayer.
Jul. 2. Hearing set July 14, 1931, St. Paul, Minn.
" 15. Hearing had before Mr. Lansdon, Div. 8. Called on merits. Briefs due in 60 days.
" 31. Transcript of hearing July 15, 1931, filed.
[fol. 4]
Aug. 8. Brief filed by taxpayer.
" 15. Brief filed by General Counsel.

1932.

Jan. 8. Findings of fact and opinion rendered, Judge Lansdon, Div. 8. Decision will be entered for the Commissioner.

" 9. Decision entered, Div. 8.

Jun. 21. Supersedeas bond in the amount of $8,500.00 approved and ordered filed.

" 21. Petition for review to U. S. Circuit Court of Appeals (8) with assignments of error, filed by taxpayer.

Jul. 5. Proof of service filed.

Aug. 6. Praecipe with affidavit of service thereon filed.

" 6. Agreed statement of evidence lodged.

" 9. Agreed statement of evidence approved and ordered filed.

BEFORE UNITED STATES BOARD OF TAX APPEALS

[Title omitted]

PETITION OF THOMAS H. WELCH IN CAUSE No. 40852—Filed Oct. 1, 1928

The above named petitioner hereby petitions for a redetermination of the deficiency set forth by the Commissioner of Internal Revenue in his notice of deficiency IT:AR:B-8-RMJ-60D dated August 2nd, 1928, and as a basis of his proceeding alleges as follows:

1. The petitioner is an individual with principal office at 501 Forest Avenue South, Minneapolis, Minnesota.

2. The notice of deficiency (a copy of which is attached and marked Exhibit A) was mailed to the petitioner on August 2nd, 1928.

3. The tax in controversy is income tax for the calendar year, 1926 and in the sum of $419.70.

[fol. 5] The determination of tax set forth in said notice of deficiency is based upon the following error:

The Commissioner of Internal Revenue erred in his ruling "that the amounts paid to former customers who lost money in a Company of which you were an officer are in the nature of gratuities and are not an ordinary and necessary expense of operation as provided by Section 214 (a) (1) of the Revenue Act of 1926".

5. The facts upon which the petitioner relies as a basis for this proceeding are as follows:

The tax payer and his father, Mr. E. L. Welch owned and operated a grain commission company under the name of E. L. Welch Company. The tax payer, during his connection with the E. L. Welch Company, induced various grain dealers to ship their grain to and otherwise trade with the E. L. Welch Company.

That during the year 1922, the E. L. Welch Company was declared bankrupt and large losses were sustained by the customers of the said Company. The customers secured through the direct solicitation and influence of the tax payer lost approximately $170,000.00. The tax payer felt morally bound to reimburse them as soon as his ability permitted, and each year since said bankruptcy, has paid out all his earnings except necessary living expenses to such customers.

During the year 1926, tax payer paid the sum of $12,651.95 to such customers because he felt morally obligated to reimburse them. That the said payments amounting to $12,651.95 were deducted from tax payer's gross income for the year 1926.

6. Wherefore, petitioner prays that this Board may hear the proceedings and review the determination of the Commission and that the petitioner be allowed to deduct the said sum of $12,651.95 from his gross income for the year 1926 in computing his individual income tax liability.

P. J. Coffey, Counsel for the Petitioner.

P. J. Coffey, 304 Yeates Building, Minneapolis, Minnesota.

Duly sworn to by Thomas H. Welch. Jurat omitted in printing.

[fol. 6] EXHIBIT "A" TO PETITION

Treasury Department, Washington

Office of Commissioner of Internal Revenue

IT:AR:B-8-RMJ-60D

August 3rd, 1928.

Mr. Thomas H. Welch, 501 Forest Avenue South, Minneapolis, Minnesota.

SIR: In accordance with Section 274 of the Revenue Act of 1926 you are advised that the determination of your tax

liability for the years 1926 discloses a deficiency of $419.70 as shown in the attached statement.

This section of the law above mentioned allows you an appeal to the United States Board of Tax Appeals within sixty days from the date of the mailing of this letter. However, if you acquiesce in this determination, you are requested to execute the inclosed Form X and forward it to the Commissioner of Internal Revenue, Washington, D. C., for the attention of IT:C:P-7.

Respectfully, D. H. Blair, by C. N. Allen, Deputy Commissioner.

Inclosures: Statement, Form X 866; Form 882.

[fol. 7] Statement

IT:AR:B-8. RMJ-60D

Aug. 2, 1928.

In re Mr. Thomas H. Welch, 501 Forest Avenue South, Minneapolis, Minn.

Year	Deficiency in tax
1926	$419.70

Reference is made to the report of the Internal Revenue Agent in Charge at Minneapolis, Minnesota, and to your protest submitted under date of May 22, 1928.

Careful consideration has been accorded your protest in connection with the agent's findings. The adjustment recommended by the agent has been approved for the reason that this office holds that the amounts paid to former customers who lost money in a company of which you were an officer, are in the nature of gratuities, and are not an ordinary and necessary expense of operation as provided by Section 214 (a) (1) of the Revenue Act of 1926.

Since such gratuities do not come within the purview of Article 251 of Regulations 69, they cannot be allowed as deductions for contributions.

Tax reported on return	$ 4.47
Proposed deficiency	419.70
Liability stated on Form 866	$424.17

Payment of the deficiency should not be made until a bill is received from the Collector of Internal Revenue for your district, and remittance should then be made to him.

BEFORE UNITED STATES BOARD OF TAX APPEALS

ANSWER OF COMMISSIONER OF INTERNAL REVENUE IN CAUSE No. 40852—Filed Nov. 24, 1928

The Commissioner of Internal Revenue, by his attorney, C. M. Charest, General Counsel, Bureau of Internal Revenue, for answer to the petition filed in the above-entitled appeal, admits and denies as follows:

1. Admits the allegations contained in paragraph 1.
2. Admits the allegations contained in paragraph 2.
3. Admits the allegations contained in paragraph 3.

[fol. 8] 4. Denies the respondent erred in the manner alleged and set forth in paragraph 4.

5. Denies the allegations contained in paragraph 5.

Wherefore, it is prayed that the taxpayer's appeal be denied.

(Signed) C. M. Charest, General Counsel, Bureau of Internal Revenue. Of Counsel: W. Frank Gibbs, Special Atty., Bureau of Internal Revenue.

BEFORE UNITED STATES BOARD OF TAX APPEALS

[Title omitted]

PETITION OF THOMAS H. WELCH IN CAUSE NO 51929—Filed Jan. 12, 1931

The above named petitioner hereby petitions for a redetermination of the deficiency set forth by the Commissioner of Internal Revenue in his notice of deficiency IT:AR:D-2-ILF-60D dated November 13th, 1930, and as a basis of his proceeding alleges as follows:

1. The petitioner is Thomas H. Welch, an individual, residing at 2209 Humboldt Avenue, South, Minneapolis, Minnesota.

2. The notice of deficiency (a copy of which is attached and marked Exhibit A) was mailed to the petitioner on November 13th, 1930.

3. The taxes in controversy are income taxes for the calendar year 1924 and 1925 and for $235.46 and $1,051.60 respectively.

4. The determination of tax set forth in the said notice of deficiency is based upon the erroneous disallowance of $4,000.36 for 1924 and $11,968.20 for 1925, lawful deductions from gross income.

5. The facts upon which the petitioner relies as the basis for this proceeding are as follows:

[fol. 9] (a) The sums of $4,000.36 and $11,968.20 were paid out in 1924 and 1925 respectively to customers of the taxpayer from commissions earned by him on grain shipments to the company which employed the taxpayer to solicit such shipments in 1924 and 1925.

The disbursements amounting to $4,000.36 and $11,968.20 were made by the taxpayer to customers he had personally induced to ship grain to the firm of E. L. Welch and Company, founded by the taxpayer's father and owned in part by the taxpayer and only to such customers as had lost money, and to extent of their respective losses, as the result of the bankruptcy of said E. L. Welch and Company in a prior year.

These amounts were paid in recognition of the taxpayer's moral obligation to reimburse his customers for losses incurred by them through dealing with the taxpayer.

Wherefore, the petitioner prays that this Board may hear the proceeding and allow as deductions from gross income for 1924, the sum of $4,000.36 and for 1925, the sum of $11,968.20, as allowable expenditures.

P. J. Coffey, Counsel for Petitioner, 311 Medical Arts Building, Minneapolis, Minnesota.

Duly sworn to by Thomas H. Welch. Jurat omitted in printing.

[fol. 10] EXHIBIT "A" TO PETITION

Treasury Department

Office of Commissioner of Internal Revenue

NP-2-26

Nov. 13, 1930.

Mr. Thomas H. Welch, 2209 Humboldt Avenue South, Minneapolis, Minnesota.

SIR: You are advised that the determination of your tax liability for the years 1924 and 1925, discloses a deficiency of $1,287.06, as shown in the statement attached.

In accordance with Section 274 of the Revenue — of 1926, notice is hereby given of the deficiency mentioned. Within sixty days (not counting Sunday as the sixtieth day) from the date of the mailing of this letter, you may petition the United States Board of Tax Appeals for a redetermination of your tax liability.

However, If You Do Not Desire To Petition, you are requested to execute the enclosed agreement form and forward it to the Commissioner of Internal Revenue, Washington, D. C., for the attention of IT:C:P-7. The signing of this agreement will expedite the closing of your return(s) by permitting an early assessment of any deficiency and preventing the accumulation of interest charges, since the interest period terminates thirty days after filing the enclosed agreement, or on the date assessment is made, whichever is earlier; Whereas, If No Agreement Is Filed, interest will accumulate to the date of assessment of the deficiency.

Respectfully, David Burnet, Commissioner, by W. T. Sherwood, Deputy Commissioner.

Enclosures: Statement, Form 882, Form 870.

[fol. 11] Statement

IT:AR:D-2. ILF:—60D

In re Mr. Thomas H. Welch, 2209 Humboldt Avenue South, Minneapolis, Minnesota

Tax Liability

Year	Corrected tax liability	Tax previously assessed	Deficiency
1924	$448.17	$212.71	$235.46
1925	1,307.90	256.30	1,051.60
Total	$1,756.07	$469.01	$1,287.06

An examination of your returns filed for the years 1924 and 1925 together with related schedules shows that you did not include in your gross business income amounts of $4,000.36 and $11,968.20, respectively, which represented payments made during the taxable years to old customers of E. L. Welch and Company, a dissolved corporation of which you and your father were the principal stockholders.

The company which was engaged in the grain commission business was incorporated under the laws of the State of Minnesota in 1906 with an authorized capital stock of $50,000.00. In the year 1922, the corporation was declared a bankrupt and final liquidation of the assets was made on July 2, 1926, the customers secured through your solicitation losing approximately $170,000.00.

After the dissolution of the corporation you entered into a similar business in your individual capacity. In reporting your gross income from business in the years 1924 and 1925, it appears that you omitted the respective aggregate amounts of $4,000.36 and $11,968.20, which represented payments in the nature of a partial reimbursement to customers of the defunct corporation, for which you felt morally bound, and which you, therefore, considered allowable deductions from business income in each year under the provisions of section 214 (a) (1) of the Revenue Act of 1926.

A careful consideration has been given the facts in the case. The amount of payment made by you to customers was apparently a new obligation since no agreement existed between you and the bankrupt corporation, or between you and the old customers of the corporation. The benefit anticipated from such payments was improved credit reputation and standing and was in the nature of capital expenditures which are not deductible as ordinary and neces- [fol. 12] sary expenses. In this connection your attention is directed to the decision of the United States Board of Tax Appeals in the appeal of the Herbert Brush Manufacturing Company, 15 B. T. A. page 673.

The computation of tax is as follows:

1924

Net income on return	$10,664.23
Add: Additional business income	4,000.36
Total net income	$14,664.59
Less: Personal exemption and credit for dependents	3,300.00
Amount subject to normal tax	$11,364.59

Normal tax at 2% on $4,000.00	$80.00
Normal tax at 4% on $4,000.00	160.00
Normal tax at 6% on $3,364.59	201.88
Surtax on $14,664.59 ($40.00+2% on $664.59)	53.29
Total tax	$495.17
Less: Earned income credit	47.00
Total tax assessable	$448.17
Tax previously assessed	212.71
Deficiency	$235.46

Computation of Credit on Earned Net Income

Earned net income	$10,000.00
Brought forward	$10,000.00
Less: Personal exemption and credit for dependents	3,300.00
	$6,700.00
Normal tax at 2% on $4,000.00	$80.00
[fol. 13] Normal tax at 4% on $2,700.00	108.00
Total tax	188.00
Credit of 25%	47.00

1925

Net income on return	$14,524.71
Add: Additional business income	11,968.20
Total net income	$26,492.91
Less: Personal exemption and credit for dependents	4,300.00
Amount subject to normal tax	$22,192.91

Normal tax at 1½% on $4,000.00	$60.00
Normal tax at 3% on $4,000.00	120.00
Normal tax at 5% on $14,192.91	709.65
Surtax on $26,492.91 ($440.00+7% of $2,492.91)	614.50
Total tax	$1,504.15
Less: Earned income credit	196.25
Total tax assessable	$1,307.90
Tax previously assessed	256.30
Deficiency	$1,051.60

Computation of Credit on Earned Net Income

Earned Net income	$20,000.00
Less: Personal exemption and credit for dependents	4,300.00
Balance	$15,700.00
Normal tax at 1½% on $4,000.00	$60.00
Normal tax at 3% on $4,000.00	120.00
Normal tax at 5% on $7,700.00	385.00
[fol. 14] Surtax on $20,000.00	220.00
Total tax	$785.00
Credit of 25%	196.25

Payment should not be made until a bill is received from the Collector of internal revenue for your district and remittance should then be made to him.

Consents which will expire December 31, 1930, except as extended by the provisions of section 277 (b) of the Revenue Act of 1926, are on file for the years 1924 and 1925.

BEFORE UNITED STATES BOARD OF TAX APPEALS

ANSWER OF COMMISSIONER OF INTERNAL REVENUE IN CAUSE No. 51929—Filed Feb. 5, 1931

The Commissioner of Internal Revenue, by his attorney, C. M. Charest, General Counsel, Bureau of Internal Revenue, for answer to the petition filed in the above-entitled appeal, admits and denies as follows:

1, 2 and 3. Admits the allegations in paragraphs 1, 2 and 3.

4. Denies the respondent erred as alleged and set forth in paragraph 4.

5. Denies the allegations in paragraph 5.

Wherefore, it is prayed that the taxpayer's appeal be denied.

(Signed) C. M. Charest, General Counsel, Bureau of Internal Revenue. Of Counsel: W. Frank Gibbs, Special Atty., Bureau of Internal Revenue.

BEFORE UNITED STATES BOARD OF TAX APPEALS

[Title omitted]

PETITION OF THOMAS H. WELCH IN CAUSE No. 53119—Filed Feb. 24, 1931

[fol. 15] The above named petitioner hereby petitions for a redetermination of the deficiency set forth by the Commissioner of Internal Revenue in his notice of deficiency IT:AR:D-1-CMS-60D, dated January 13th, 1931, and as the basis of his proceeding alleges as follows:

1. The petitioner is Thomas H. Welch, an individual residing at 2209 Humboldt Avenue South, Minneapolis, Minnesota.

2. The notice of deficiency (a copy of which is attached and marked Exhibit A) was mailed to the petitioner on January 13th, 1931.

3. The taxes in controversy are income taxes for the calendar years 1927 and 1928 and for $546.83 and $819.37 respectively.

4. The determination of tax set forth in the said notice of deficiency is based upon the erroneous disallowance of $7,678.43 for 1927 and $11,150.00 for 1928, lawful deductions from gross income.

5. The facts upon which the petitioner relies as the basis for this proceeding are as follows:

(a) The sums of $7,678.43 and $11,150.00 were paid out in 1927 and 1928 respectively to customers of the taxpayer from commissions earned by him on grain shipments to the company which employed the taxpayer to solicit such shipments in 1927 and 1928. These disbursements were made by the petitioner to customers he had personally in-

duced to ship grain to E. L. Welch and Company, a corporation founded by the petitioner's father and owned in part by the petitioner and only to such customers as had lost money, and to the extent of their respective losses as the result of the bankruptcy of said E. L. Welch and Company in a prior year.

Wherefore the petitioner prays that this Board may hear the proceeding and allow as deductions from gross income for 1927, the sum of $7,678.43 and for 1928 the sum of $11,150.00 as allowable expenses.

P. J. Coffey, Counsel for Petitioner, 311 Medical Arts Building, Minneapolis, Minnesota.

Duly sworn to by Thomas H. Welch. Jurat omitted in printing.

[fol. 16] EXHIBIT "A" TO PETITION

Treasury Department, Washington

Office of Commissioner of Internal Revenue

NP-2-26-28

Address reply to Commissioner of Internal Revenue and refer to ——.

Jan. 13, 1931.

Mr. Thomas H. Welch, 501 Forest Avenue South, Minneapolis, Minnesota.

SIR: You are advised that the determination of your tax liability for the years 1927 and 1928 discloses a deficiency of $1,366.20 as shown in the statement attached.

In accordance with section 274 of the Revenue Act of 1926 and section 272 of the Revenue Act of 1928, notice is hereby given of the deficiency mentioned. Within sixty days (not counting Sunday as the sixtieth day) from the date of the mailing of this letter, you may petition the United States Board of Tax Appeals for a redetermination of your tax liability for the years in which a deficiency is disclosed.

However, If You Do Not Desire To Petition, you are requested to execute the enclosed agreement form and forward it to the Commissioner of Internal Revenue, Washington, D. C., for the attention of IT:C:P-7. The signing of this agreement will expedite the closing of your returns by permitting an early assessment of any deficiency and preventing the accumulation of interest charges, since the interest period terminates thirty days after filing the enclosed [fol. 17] agreement, or on the date assessment is made, whichever is earlier; Whereas If No Agreement Is Filed, interest will accumulate to the date of assessment of the deficiency.

Respectfully, David Burnet, Commissioner, by W. T. Sherwood, Acting Deputy Commissioner.

Enclosures: Statement, Form 882, Form 870.

Statement

IT:AR:D-1. CMS-60D

In re Mr. Thomas H. Welch, 501 Forest Avenue South, Minneapolis, Minnesota

Tax Liability

Years	Corrected tax liability	Tax previously assessed	Deficiency
1927	$849.49	$302.66	$546.83
1928	1,103.10	283.73	819.37
Totals	$1,952.59	$586.39	$1,366.20

The reports of the internal revenue agent in charge, St. Paul, Minnesota covering your tax liability for the years 1927 and 1928 have been reviewed by this office and approved as submitted.

The following adjustments have been made:

1927

Net income reported	$14,739.89
Add 1. Income from salaries	7,727.70
Adjusted net income	$22,467.59

[fol. 18] Computation of Tax

Net income adjusted	$22,467.59
Less: Personal exemption and credit for dependents	4,300.00
Balance subject to normal tax	$18,167.59
Normal tax at 1½% on $4,000.00	$60.00
Normal tax at 3% on $4,000.00	120.00
Normal tax at 5% on $10,167.59	508.38
Surtax on $22,467.59	348.06
Total tax	$1,036.44
Less: Credit on 25% of tax on earned net income	186.95
Tax liability	$849.49
Tax previously assessed	302.66
Deficiency in tax	$546.83

Explanation of Change

1. The amount reported as commissions received from Kellogg Commission Company was overstated by $241.33.

Included in the amount representing total expenses claimed as a deduction against salaries received was an item of $290.60, claimed for interest paid. This amount has been disallowed since it was also claimed as a deduction under item 11 of your return.

The amount of $7,678.43 claimed as a deduction against salaries received and explained as payments made to creditors of E. L. Welch Company, has been disallowed as not representing ordinary and necessary expenses paid or incurred during the taxable year in carrying on a trade or business as defined by section 214 (a) (1) of the Revenue Act of 1926.

1928

Net income reported	$15,109.31
Add: 1. Income from salary	11,150.00
Adjusted net income	$26,259.31

[fol. 19] Computation of Tax

Net income adjusted	$26,259.31
Less: Personal exemption and credit for dependents	4,300.00
Balance subject to normal tax	$21,959.31
Normal tax at 1½% on $4,000.00	$60.00
Normal tax at 3% on $4,000.00	120.00
Normal tax at 5% on $13,959.31	697.97
Surtax on $26,259.31	598.15
Total tax	$1,476.12
Less: Credit of 25% of tax on earned net income	373.02
Tax liability	$1,103.10
Tax assessed	283.73
Deficiency in tax	$819.37

Explanation of Change

1. This amount, representing payments made to creditors of E. L. Welch Company, and claimed as a deduction against salary received, has been disallowed as not coming within the provisions of section 23 (a) of the Revenue Act of 1928.

Due to the fact that the statute of limitations will presently bar any assessment of additional tax against you for the years 1927 and 1928 the Bureau will be unable to afford you an opportunity under the provisions of article 1211 of Regulations 69 and article 451 of Regulations 74 to discuss your case before mailing formal notice of its determination as provided by section 274 (a) of the Revenue Act of 1926 and section 272 (a) of the Revenue Act of 1928. It is, therefore, necessary at this time to issue this formal notice of deficiency.

[fol. 20] Form 870.

Treasury Department, Internal Revenue Service.
Revised October, 1930.
IT:C:P-7.

In re Mr. Thomas H. Welch, 501 Forest Avenue South, Minneapolis, Minnesota

Waiver of Right to File a Petition with the United States Board of Tax Appeals

The undersigned taxpayer hereby waives the right to file with the United States Board of Tax Appeals under Section 274 (a) of the Revenue Act of 1926, and/or Section 272 (a) of the Revenue Act of 1928, and consents to the assessment and collection of a deficiency in income tax for the

calendar year ended December 31, 1927 in the sum of $546.83
calendar year ended December 31, 1928 in the sum of $819.37
.....year ended .....in the sum of $.....

amounting to the total sum of $1,366.20

together with interest thereon as provided by law.

(Name:) —— ——, (Address:) ——, by —— ——.
Date: —— —, ——.

Note.—This waiver does not extend the statute of limitations for refund or assessment of tax, and is not an agreement as provided under Section 606 of the Revenue Act of 1928, but its execution and filing at the address shown in the accompanying letter will expedite the adjustment of your income tax liability as indicated above.

Where the taxpayer is a corporation, the agreement shall be signed with the corporate name, followed by the signature and title of such officer or officers of the corporation as are empowered to sign for the corporation, in addition to which the seal, if any of the corporation must be affixed.

[fol. 21] Before United States Board of Tax Appeals

Answer of Commissioner of Internal Revenue in Cause No. 53119—Filed Mar. 13, 1931

The Commissioner of Internal Revenue, by his attorney, C. M. Charest, General Counsel, Bureau of Internal Rev-

enue, for answer to the petition filed in the above-entitled appeal, admits and denies as follows:

1, 2 and 3. Admits the allegations in paragraphs 1, 2 and 3.

4. Denies the respondent erred as alleged and set forth in paragraph 4.

5. Denies the allegations contained in paragraph 5(a).

Wherefore, it is prayed that the taxpayer's appeal be denied.

(Signed) C. M. Charest, General Counsel, Bureau of Internal Revenue. Of Counsel: W. Frank Gibbs, Special Attorney, Bureau of Internal Revenue.

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25 B. T. A. —

BEFORE UNITED STATES BOARD OF TAX APPEALS

Docket Nos. 40852, 51929, 53119

THOMAS H. WELCH, Petitioner

vs.

COMMISSIONER OF INTERNAL REVENUE, Respondent

Promulgated January 8, 1932

In order to re-establish his credit and to secure customers for his individual business from among those who had been customers of a corporation of which he was an officer, petitioner partially reimbursed those who had sustained losses when the corporation was discharged in bankruptcy. Held, that such amounts may not be deducted as "ordinary and necessary expense."

[fol. 22] Alexander E. Horn, Esq., and P. J. Coffey, Esq., for the petitioner.

C. H. Curl, Esq., for the respondent.

FINDINGS OF FACT AND OPINION

The respondent has asserted deficiencies in income taxes for the years 1924 to 1928, inclusive, in the respective amounts of $235.46, $1,051.60, $419.70, $546.83 and $819.37.

The single issue presented is whether, in the circumstances of these proceedings, the petitioner is entitled to deduct, as ordinary and necessary business expenses, certain amounts paid to reimburse creditors of a corporation, for losses sustained when the corporation was discharged in bankruptcy.

Findings of Fact

The petitioner is an individual residing in Minneapolis. During 1922, he was secretary of the E. L. Welch Company, a Minnesota corporation, engaged in the grain business. Except for 10 shares of stock owned by him, all the stock of E. L. Welch Company was owned by petitioner's father.

For several years prior to 1922, petitioner had been in close touch with the customers of E. L. Welch Company, having traveled through the territory for three or four months each summer making contacts with present and prospective customers. He handled all grain as it came in to Minneapolis, and attended to grading and sale. Petitioner's father looked after the financial end of the business only.

On March 23, 1922, the E. L. Welch Company was adjudged an involuntary bankrupt. The petitioner was adjudged a voluntary bankrupt on August 5, 1922. In due course each was discharged from existing debts. Shortly thereafter, the petitioner entered into a contract with the Kellogg Company, to purchase grain for it on a commission basis. In order to re-establish his standing and credit, and to revive new business contacts with former customers of the E. L. Welch Company, the petitioner determined, as far as he was able, to reimburse certain creditors of the E. L. Welch Company. Beginning in 1924, he made small payments to all of the numerous creditors, except two, by a special check which bore the following endorsement:

The payee of this check, by the endorsement hereof, accepts and agrees to apply the same on its claim against E. L. Welch Company, according to the terms of the letter of transmittal. It has nothing to do with present or future business relations with the maker of the check and is not to be considered as acknowledging any existing claim or renewing any barred claim against him.

[fol. 23] From 1924 to 1928, the petitioner earned commissions and made payments to reimburse creditors of the E. L. Welch Company as follows:

Year	Commissions	Credits of E. L. Welch Co.
1924	$18,028.20	$3,975.97
1925	31,377.07	11,968.20
1926	20,925.25	12,815.72
1927	22,119.61	7,379.72
1928	26,177.56	11,068.25

On his income tax returns for 1924, 1925 and 1926, the petitioner reported only the amount remaining from commissions earned after payments of the above amounts to creditors of the E. L. Welch Company. On his income tax returns for 1927 and 1928, he reported the total commissions received and deducted the payments to creditors of the E. L. Welch Company. The respondent has added to income the payments for 1924, 1925 and 1926, and has disallowed the deductions taken in 1927 and 1928.

Opinion

LANSDON:

We think the respondent correctly disallowed the deductions claimed. If the payments relate at all to "carrying on a trade or business" they still may not be allocated as expense of any particular year. Doubtless petitioner more quickly re-established his standing and credit and built up his new business by reimbursing those who had lost money through a corporation dominated by him and his father, but we do not understand payments of such a nature to be ordinary and necessary business expenses.

In two recent decisions we have held that the payment of discharged obligations for the purpose of re-establishing credit resulted in the acquisition of an intangible capital asset, in the nature of good will, which had a probable life co-extensive with the business. Herbert Brush Manufacturing Co., 15 B. T. A. 673; and A. Harris & Co., 16 B. T. A. 705. The latter case was reversed by the Circuit Court of Appeals for the Fifth Circuit in A. Harris & Co. vs. Lucas, 48 Fed. (2d) 187, and the deduction claimed was allowed. The facts of the instant proceeding are distinguished from those of the Harris case. There a mercantile

establishment, which had been discharged from its debts in a compromise settlement, reimbursed its former creditors in an effort to re-establish its credit so that it could buy without having to pay cash for each order. Here the [fol. 24] bankrupt corporation is no longer in business and an individual is seeking to build up a business by reimbursing creditors of the corporation who have lost money.

Decision will be entered for the respondent.

BEFORE UNITED STATES BOARD OF TAX APPEALS, WASHINGTON

Docket No. 40852

THOMAS H. WELCH, Petitioner,

vs.

COMMISSIONER OF INTERNAL REVENUE, Respondent

ORDER OF REDETERMINATION—January 9, 1932

Pursuant to the determination of the Board, as set forth in its report promulgated January 8, 1932, it is

Ordered and Decided: That there is a deficiency of $419.70 for the year 1926.

Enter.

(Signed) W. C. Lansdon, Member.

Entered Jan. 9, 1932.

A true copy. Teste:

B. D. Gamble, Clerk U. S. Board of Tax Appeals.

(Seal.)

BEFORE UNITED STATES BOARD OF TAX APPEALS, WASHINGTON

51929

THOMAS H. WELCH, Petitioner,

vs.

COMMISSIONER OF INTERNAL REVENUE, Respondent

ORDER OF REDETERMINATION—January 9, 1932

Pursuant to the determination of the Board, as set forth in its report promulgated January 8, 1932, it is

[fol. 25] Ordered and Decided: That there are deficiencies of $235.46 and $1,051.60 for the years 1924 and 1925, respectively.

(Signed) W. S. Lansdon, Member.

Entered Jan. 9, 1932.

A true copy. Teste:
B. D. Gamble, Clerk U. S. Board of Tax Appeals.
(Seal.)

BEFORE UNITED STATES BOARD OF TAX APPEALS, WASHINGTON

Docket No. 53119

THOMAS H. WELCH, Petitioner,

vs.

COMMISSIONER OF INTERNAL REVENUE, Respondent

ORDER OF REDETERMINATION—January 9, 1932

Pursuant to the determination of the Board, as set forth in its report promulgated January 8, 1932, it is

Ordered and Decided: That there are deficiencies of $546.83 and $819.37 for the years 1927 and 1928, respectively.

Enter.

(Signed) W. C. Lansdon, Member.

Entered Jan. 9, 1932.

A true copy. Teste:
B. D. Gamble, Clerk U. S. Board of Tax Appeals.
(Seal.)

BEFORE UNITED STATES BOARD OF TAX APPEALS

Docket Nos. 40852, 51929 and 53119 Consolidated for Hearing and Decision

[Title omitted]

PETITION OF THOMAS H. WELCH FOR REVIEW OF DECISION OF UNITED STATES BOARD OF TAX APPEALS—Filed June 21, 1932

The petition of the above named Thomas H. Welch respectfully shows:

[fol. 26] I

That on January 8, 1932 the above named United States Board of Tax Appeals promulgated its decision in the above entitled matter in favor of respondent and against petitioner and on January 9, 1932 said Board entered its order of redetermination that there are deficiencies in the income tax of petitioner for the years 1924 to 1928, both inclusive, payable by petitioner to respondent as follows:

For the year 1924	$235.46
" " " 1925	1,051.60
" " " 1926	419.70
" " " 1927	546.83
" " " 1928	819.37
Total	$3,072.96

II

Petitioner is and has been during all the times herein stated an inhabitant and also a resident of the City of Minneapolis and the State of Minnesota in the said Eighth Circuit and during said period during the years 1924 to 1928, both inclusive, made his annual return of his Federal income and excess profits tax to the Collector of Internal Revenue at said City of Minneapolis.

The United States Circuit Court of Appeals of the Eighth Circuit has jurisdiction to review said decision under Sections 1001, 1002, and 1003 of the Revenue Act of 1926, and a review of said decision and order of redetermination is sought by petitioner by the United States Circuit Court of Appeals of the Eighth Circuit.

III

The nature of the controversy is as follows:

E. L. Welch & Company, a Minnesota Corporation, with its principal place of business at the City of Minneapolis, engaged in business throughout the Northwest of buying and selling grain on commission, was adjudged an involuntary bankrupt on March 23, 1922. Its liabilities were about $500,000. It was discharged in 1926.

Petitioner was adjudged a voluntary bankrupt on August 25, 1922, and was discharged in October, 1922. The outstanding capital stock of the corporation at the time of the

adjudication was $50,000. Petitioner was secretary of the company and held one thousand dollars and his father, E. L. Welch, president and treasurer, held the balance of [fol. 27] the shares. The corporation handled a large volume of cash grain. The largest part of its business was handling grain on commission. Petitioner was in close touch with the customers and took complete charge of the grain as it came in. He also handled cash grain.

After the adjudication and in the years 1924 to 1928 inclusive, he was engaged in the same business as the corporation had been in and in the same territory and with some of its old customers—that is, selling grain on commission.

His gross income for these years was $118,818.41, which income was received as commission from sales of grain. Of this amount he paid an income tax on $71,610.55. He did not pay any income tax on the balance of $47,207.86—this amount he paid to the creditors of the corporation existing at the time of its adjudication in bankruptcy.

His gross income for each year was:

Years	A	B
1924	$14,052.23	$3,975.97
1925	19,408.87	11,968.20
1926	8,300.25	12,815.72
1927	14,739.89	7,379.72
1928	15,109.31	11,068.25
	$71,610.55	$47,207.86

Colum A represents amounts on which the income tax was paid and Column B the amounts paid to creditors of the corporation and on which no income tax was paid.

Petitioner in his income tax returns for the years 1924 to 1926, both inclusive, reported the amounts in Column A and in his returns for the years 1927 and 1928 reported the full amount of his earnings in Columns A and B. The motives of petitioner in making these payments to the creditors of the corporation (Column B) were to re-establish his standing and credit and build up new business. He then claimed and now claims that these payments (Column B) were, under Section 214 (a) Revenue Act of 1926, ordinary and necessary expenses paid during the taxable year

in carrying on his business and that the payments in each of the years in question were proper deductions in the year when made from his gross income of that year.

The determination of the Board was that these payments could not be considered a business expense but were a capital expenditure and not deductible from gross income but if they were a business expense they could not be allo- [fol. 28] cated as an expense in the particular year when made and for these reasons were not proper deductions from income but were taxable income.

IV

Assignments of Error

Your petitioner states that in said petition manifest errors were contained to his prejudice, that is to say the said United States Board of Tax Appeals erred:

1. In ordering the entry of judgment in favor of respondent.

2. In ordering and deciding that upon redetermination there was a deficiency in the amounts above stated for each of said years 1924 to 1928, both inclusive, and in sustaining respondent in disallowing the deductions claimed by petitioner for each of said years in the amount stated in Column B.

3. In ordering and deciding that the amounts paid to creditors of the corporation (Column B) for the years 1924 to 1928, both inclusive, and each of said years, were not an ordinary and necessary expense of carrying on the business of petitioner and were not proper deductions for any of said years from gross income for the reason that there is no evidence to support such a finding, and it being contrary to the evidence, and that the evidence conclusively and without contradiction established the fact that such payments in each of said years were ordinary and necessary expenses of carrying on the business of petitioner.

4. In holding and deciding that said payments (Column B) could not be allocated as an expense of any particular year when made for the reason that there is no evidence to support such a finding and it being contrary to the evidence and that the evidence conclusively and without contradiction established the fact that such payments in each

of said years were made as stated in Column B and a proper deduction from gross income in each of said years.

5. In refusing to hold that said payments (Column B) were ordinary and necessary expenses of carrying on the business of petitioner during each of said years and that the same could be properly allocated as an expense of each particular year on the ground that the evidence conclusively and without contradiction established that such was a fact.

6. In denying the motion of petitioner for judgment.

[fol. 29] Wherefore, Petitioner prays that said decision and order of redetermination by the United States Board of Tax Appeals in the above proceedings be reversed.

Dated this 7th day of June, 1932.

Alexander E. Horn, Attorney for Petitioner, 1116 Pioneer Building, St. Paul, Minnesota. Thomas H. Welch, Petitioner.

Duly sworn to by Thomas H. Welch. Jurat omitted in printing.

BEFORE UNITED STATES BOARD OF TAX APPEALS

Docket Numbers 40852, 51929 and 53119, Consolidated for Hearing and Decision

[Title omitted]

NOTICE OF PETITION FOR REVIEW AND ADMISSION OF SERVICE—Filed July 5, 1932

Please Take Notice that the petition for review of the petitioner in the above entitled matter, to the United States Circuit Court of Appeals for the Eighth Circuit has been filed with the Clerk of the above named United States [fol. 30] Board of Tax Appeals, a copy of which petition is hereto attached and herewith served upon you.

Dated June 22, 1932.

(Signed) Alexander E. Horn, Attorney for Petitioner, 1116 Pioneer Building, St. Paul, Minnesota.

Due service of the within Notice by true copy, and also service of the petition for review therein referred to is admitted at Washington, D. C., this 23rd day of June, 1932.

(Signed) C. M. Charest, Attorney for Commissioner of Internal Revenue.

BEFORE UNITED STATES BOARD OF TAX APPEALS

Docket Numbers 40852, 51929 and 53119, Consolidated for Hearing and Decision

THOMAS H. WELCH, Petitioner,

vs.

COMMISSIONER OF INTERNAL REVENUE, Respondent

Statement of Evidence—Received Aug. 6, 1932; Lodged Aug. 6, 1932; Filed Aug. 9, 1932

Be it remembered that the above matter came on for hearing July 15th, 1931, before the Honorable William C. Lansdon, member of the United States Board of Tax Appeals, at St. Paul, Minnesota, Alexander E. Horn appearing on behalf of petitioner and C. H. Curl appearing on behalf of Respondent.

THOMAS H. WELCH, petitioner, was duly sworn as petitioner on his own behalf and testified as follows:

My age is forty-four years. I reside in Minneapolis, Minnesota. I was Secretary of E. L. Welch Company, a Minnesota corporation, in 1922. The outstanding capital stock was $50,000. I owned ten shares. The balance of the shares was owned by my father, E. L. Welch, who was President.

[fol. 31] The corporation was adjudged an involuntary bankrupt March 23, 1922, and discharged July 6, 1926.

I was adjudged a voluntary bankrupt August 5, 1922, and discharged October 25, 1922.

At the time of its adjudication in bankruptcy, and for some years prior thereto, this corporation handled a large volume of cash grain and other grain futures, what is known as grain business. The largest part of its business was handling grain on commission. I had charge of the

actual handling of the cash grain—commission business and also looking — future business. I was in very close touch with the customers of the corporation and travelled out in the country through the summer and fall three or four months, and then took complete charge of the grain as it came in, and handled the cash grain and practically loaded 85 or 90 per cent, in addition to cash sales, the details in regard to it, the grading of grain and trading and futures.

My father took charge of the financial business entirely.

After the bankruptcy, I engaged in the grain commission business, and did business in the same territory that the corporation had been doing business in.

The following is a statement each year of my gross income (Column A)—the amounts on which I paid an income tax (Column B), and the amounts I paid to the creditors of the corporation, and on which no income tax was paid (Column C):

	A	B	C
1924	$18,028.20	$14,052.23	$3,975.97
1925	31,377.07	19,408.87	11,968.20
1926	20,952.20	8,300.25	12,651.95
1927	22,119.61	14,739.89	7,379.72
1928	26,177.56	15,109.31	11,068.25
	$118,654.64	$71,610.55	$47,044.09

On his income tax return for 1924, 1925 and 1926 the petitioner reported only the amount remaining from the commissions earned after payments of the above amounts to creditors of E. L. Welch Company. On his income tax returns for 1927 and 1928 he reported the total commissions received and deducted payments to creditors of E. L. Welch Company. The respondent has added to income the payments for 1924, 1925 and 1926 and has disallowed deductions taken in 1927 and 1928.

[fol. 32] The creditors were paid by my checks, mailed with letter of transmittal, and each check had the following endorsement:

"The payee of this check by the endorsement thereof accepts and agrees to apply the same on its claim against E. L. Welch Company according to the terms of the letter of transmittal. This has nothing to do with present or future business relations with the maker of the check and

is not to be considered as acknowledging any existing claim or renewing any barred claim against him."

The payments made to creditors in 1924 were made to practically all of the creditors of the corporation and included shippers of cash grain and future trade balances and bank paper, and also small bills such as for water and printing bill, and so forth. In fact they were all paid. Every creditor in excess of $25 was paid $25, and every creditor up to $25 was paid in full. The purpose of that was to get rid of small accounts as far as I could.

Of the amounts I paid to creditors in 1924, the sum of $1,226.58 represents claims that were paid in full. I took an assignment of these claims because the corporation was still in bankruptcy. No assignment was taken for the balance of the payments.

My checks were sent out in the same manner and with the same endorsement in 1925. The payment to each creditor was $100. These creditors were practically the same who received payments in 1924—with a few exceptions and some additions. All of the small accounts were paid in full in 1924.

Of the amounts paid to creditors in 1925 I took assignments of claims amounting to $1,228.20, but did not take any assignments for the balance.

Checks were sent out in the same manner and with the same endorsement in 1926, 1927 and 1928, and no assignments were taken for any part of the claims for any of these years.

All of the payments in 1924 to 1928, inclusive, were payments made to creditors of the corporation existing at the time of its adjudication in bankruptcy.

These payments included claims of the following banks, namely: First National Bank of St. Paul; Midland National Bank, Minneapolis; Manufacturers National Bank, Minneapolis; City National Bank, Duluth; First National Bank, [fol. 33] LeSeuer, Minnesota; Staple County Bank of Henderson, Minnesota, and the Security State Bank of Shakopee, Minnesota, and these payments to these banks included practically all of the bank creditors of the corporation.

The claims against the corporation amounted to about $500,000 and the claims of creditors to whom I made the payments amounted to about $300,000. The balance of

$200,000 was claims of the Security Elevator Company and the Carson Mill Company at Fairbanks. They were both indebted to the Welch Corporation at the time of its failure. I did not pay anything on these two claims because I did not consider that they were valid claims against the Welch Corporation.

A very large number of the creditors to whom I made payments were personal friends and customers of mine of long standing in the business.

Q. "Had they been induced in the first instance, while the corporation was a going concern to do business with the corporation on the strength of their acquaintance with you?"

A. "They had."

I talked to Mr. Jaffray, President of the First National Bank of Minneapolis before I went into bankruptcy and told him what my plan was, to pay the creditors in connection with the old company and my intention was to pay every legitimate claim, every valid claim. His advice was that if a man went through bankruptcy with the idea of beating his creditors and avoiding paying his just debts that all bankers considered him absolutely crooked, but if a man went through bankruptcy with the idea of getting a new start and making up his claims, that they considered him 100 per cent.

I went to three bankers and they all had the same opinion. I wanted to get away of going through bankruptcy if I could and that is why I went to them.

Q. "You found by following that advice that you were successful in your business thereafter, weren't you?"

A. "Yes, sir."

Q. "And you built up a large business, largely because you acted square with these creditors, isn't that a fact?"

A. "Yes, sir, to a certain extent."

Q. "Yes, and you are doing business today with a large number of them, aren't you?"

A. "A number of them, yes."

[fol. 34] Q. "What is the motive or reason for the payments that you made on these claims?"

A. "Well, it was to reestablish my credit for one thing, reestablish my business, and, further, it was a matter of a moral obligation."

I reported and disclosed in my income tax returns for 1924, 1925 and 1926 only the amounts in Column B because Mr. Carr, a tax expert in Mimeapolis, told me it was not necessary to report the amounts paid to creditors (Column C) and later on, I think it was about a year after the 1924 payment, he referred to a decision of the Tax Appeal Board made in the Herschel Jones case and said the decision fitted my case exactly. Mr. Carr made all my income tax returns and I gave him a complete statement of every dollar I earned in each of the years in question, and he made my income tax returns from this information. I sent in the returns the way he made them up.

Judgment for deficiencies was entered in favor of respondent, viz:

1924	$235.46
1925	1,051.60
1926	419.70
1927	546.83
1928	819.37
	$3,072.96

Petitioner's motion for judgment in his favor was denied.

STIPULATION RE STATEMENT OF EVIDENCE

It Is Stipulated that the foregoing statement of evidence contains all the evidence material to the assignment of errors, and may be settled by a member of the United States Board of Tax Appeals, without notice to either party.

Dated July 21, 1932.

Alexander E. Horn, Attorney for Petitioner. C. M. Charest, Attorney for Respondent. (S.)

[fol. 35] BEFORE UNITED STATES BOARD OF TAX APPEALS

APPROVAL OF STATEMENT OF EVIDENCE

Now, therefore, the foregoing statement of the evidence is approved and settled and ordered filed.

Dated Aug. 9, 1932.

W. C. Lansdon, Member of United States Board of Tax Appeals. (S.)

BEFORE UNITED STATES BOARD OF TAX APPEALS

Docket Numbers 40852, 31929 and 53119, Consolidated for Hearing and Decision

[Title omitted]

PRECIPE FOR TRANSCRIPT—Filed Aug. 6, 1932

To B. D. Gamble, Clerk of the above U. S. Board of Tax Appeals:

Please prepare, certify and transmit to the Clerk of the United States Circuit Court of Appeals for the Eighth Circuit at St. Louis, Missouri, the following in the above entitled actions, namely:

1. Docket entry of proceedings before the Board.
2. All pleadings before the Board.
3. Findings of fact, opinion and decision of the Board.
4. Petition for review with admission of service and date of filing.
5. Statement of evidence as agreed on, approved and settled.

(Signed) Alexander E. Horn, Attorney for Petitioner, 1116 Pioneer Building, St. Paul, Minnesota.

[fol. 36] Clerk's certificate to foregoing transcript omitted in printing.

[fol. 36a] Appearances of counsel omitted in printing.

[fol. 37] Minute entry of argument and submission, December 10, 1932, omitted in printing.

[fol. 38] IN UNITED STATES CIRCUIT COURT OF APPEALS, EIGHTH CIRCUIT, MARCH TERM, A. D. 1933

No. 9585

THOMAS H. WELCH, Petitioner

vs.

COMMISSIONER OF INTERNAL REVENUE, Respondent

On Petition to Review Decision of United States Board of Tax Appeals

Mr. Alexander E. Horn (Mr. Thomas D. O'Brien and Mr. Edward S. Stringer were with him on the brief), for petitioner.

Mr. J. P. Jackson, Special Assistant to the Attorney General (Mr. G. A. Youngquist, Assistant Attorney General, Mr. Sewall Key, Special Assistant to the Attorney General, Mr. C. M. Charest, General Counsel, Bureau of Internal Revenue, and Mr. Hugh Brewster, Special Attorney, Bureau of Internal Revenue, were with him on the brief), for respondent.

Before Stone, Van Valkenburgh and Booth, Circuit Judges

OPINION—Filed March 24, 1933

STONE, Circuit Judge, delivered the opinion of the court.

This is a petition to review a decision of the Board of Tax Appeals, affirming an assertation by the Commissioner of deficiencies in the income taxes of this petitioner for the years 1924 to 1928, inclusive.

The deficiencies are properly asserted unless the income for the involved years is to be reduced by certain payments [fol. 39] which the taxpayer contends are properly deductible business expenses. The character of these payments is as follows. Prior to and in the year 1922, petitioner was a minor stockholder and secretary of the E. L. Welch Company, a Minnesota corporation engaged in the grain marketing business. Petitioner was in close touch with the customers of this company and handled their grain coming into Minneapolis and attended to the grading and sale thereof there. In 1922, the company was adjudged an involuntary bankrupt, and later in the same year this petitioner was adjudged a voluntary bankrupt. In due course both the company and petitioner received discharges.

Thereafter, the petitioner entered into a contract with another company to purchase grain for it on a commission basis. In order to reestablish his standing and credit, and to revive business contacts with former customers of the Welch Company, the petitioner determined, as far as he was able, to reimburse certain creditors of that company for balances due after the discharge in bankruptcy of that company. Beginning in 1924, and continuing into 1928, he made payments to various of these creditors. It is these payments which he now claims as proper deductible business expenses. The question thus presented is purely one of law. Its solution depends upon a construction of the sections of the pertinent revenue statutes and the application of the undisputed situation here thereto. The statutes involved are Sections 214 (a) (1) of the Revenue Acts of 1924 and 1926 and Section 23 (a) of the Act of 1928. These sections contain identical provisions to the effect that the taxpayer may have as a deduction from gross income "all the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business." The question is whether these expenses are "ordinary and necessary," within the meaning of the statute. Words used in a statute are to be taken in their usual, everyday meaning, and this is particularly true of revenue statutes (United States v. Kirby Lumber Co., 284 U. S. 1, 3; Woolford Realty Co. v. Rose, 286 U. S. 319). The deductible expenses must be both "necessary" and "ordinary" (Lloyd v. Commissioner, 55 Fed. (2d) 842, 844, C. C. A. 7). There may be room for argument and difference as to whether payments of this character, under the circumstances here, are "necessary," or not. It would be rather clear that they would be helpful in a business way and that helpfulness might approach or reach necessity. However, we can see no possible basis upon which payments [fol. 40] of this character can be treated, as "ordinary" expenses of his business (Robinson v. Commissioner, 53 Fed. (2d) 810, 811, C. C. A. 8, and see Lloyd v. Commissioner, 55 Fed. (2d) 842, C. C. A. 7, and Hubinger v. Commissioner, 36 Fed. (2d) 724, 726, C. C. A. 2). In fact, they are very extraordinary payments, and not expenses of the business at all. They are unlike the payments in Harris v. Lucas, 48 Fed. (2d) 187, C. C. A. 5, but are voluntary payments similar to those treated in Robinson v. Commissioner, 53

Fed. (2d) 810, 811, C. C. A. 8, and Mastin v. Commissioner, 28 Fed. (2d) 748, 753, C. C. A. 8. While these payments are highly commendable from an ethical standpoint, we are bound by the law as written.

The determination of the Board was correct and the petition for review must be and is dismissed.

[fol. 41] IN UNITED STATES CIRCUIT COURT OF APPEALS, EIGHTH CIRCUIT.

No. 9585

THOMAS H. WELCH, Petitioner,

vs.

COMMISSIONER OF INTERNAL REVENUE

DECREE—March 24, 1933

On Petition to Review Decision of United States Board of Tax Appeals.

This cause came on to be heard on the petition to review a decision of the United States Board of Tax Appeals, affirming an assertation by the Commissioner of Internal Revenue of deficiencies in the income taxes of the petitioner for the years 1924 to 1928, inclusive, and was argued by counsel.

On Consideration Whereof, It is now here ordered, adjudged and decreed, by this Court, that the determination of the Board of Tax Appeals in this cause, be, and the same is hereby, approved and confirmed.

It is further ordered that the petition to review herein, be, and it is hereby, dismissed, without costs to either party in this Court.

[fol. 42] IN UNITED STATES CIRCUIT COURT OF APPEALS

PETITION FOR STAY OF MANDATE—Filed April 7, 1933

To the Honorable Judges of the Circuit Court of Appeals for the Eighth Circuit:

Thomas H. Welch, the above named petitioner, respectfully shows that on March 24, 1933, this Court duly entered its judgment and decree denying the petition herein to review the decision of the Board of Tax Appeals.

Your petitioner, feeling aggrieved by the decree of this Court, expects to apply to the Supreme Court of the United States for a writ of certiorari to review the judgment and decree of this Court.

The total amount of deficiencies assessed against your petitioner by the Board of Tax Appeals, and involved in this proceeding, is the sum of Three Thousand Seventy-two and 96/100 Dollars ($3,072.96), and the total interest thereon, at a very liberal estimate, does not exceed the sum of One Thousand Five Hundred Dollars ($1,500.00). At the time your petitioner filed his petition for review of the decision of said Board of Tax Appeals by this Court, your petitioner filed with said Board of Tax Appeals a bond in the sum of Eight Thousand Five Hundred Dollars ($8,500.00), a copy of which bond is hereto attached and marked Exhibit "A", and said bond is still in full force and effect. The surety on said bond was and is wholly solvent, and payment of any sum ultimately adjudged to be due from your petitioner is amply secured, and there is no need of further security as a condition to the stay of the mandate prayed for herein.

Wherefore, Your petitioner prays that the mandate in this cause from this Court to the Board of Tax Appeals be stayed pending petitioner's application to the Supreme [fols. 43-48] Court of the United States for a writ of certiorari.

Thomas H. Welch, by E. S. Stringer, his Attorney.

Duly sworn to by E. S. Stringer. Jurat omitted in printing.

Exhibit "A" to petition for stay omitted in printing.

[fol. 49] [File endorsement omitted.]

IN UNITED STATES CIRCUIT COURT OF APPEALS

ORDER STAYING ISSUANCE OF MANDATE—April 7, 1933

Thomas H. Welch having filed herein his petition representing that he expects to apply to the Supreme Court of the United States for a writ of certiorari to review the judgment and decree of this Court, and praying that the mandate herein be stayed, it is

Ordered, that the issuance of a mandate in this cause to the Board of Tax Appeals be and the same hereby is stayed for a period of thirty (30) days beyond the time when, under the rules of this Court, a mandate would in due course issue, that is to say, that the mandate herein be and hereby is stayed until and including May 23, 1933.

Provided, however, that if, within such stay, there is filed with the Clerk of this Court the certificate of the Clerk of the Supreme Court of the United States that the certiorari petition, record and brief have been filed and proof of notice thereof under the rules of the Supreme Court, such stay [fol. 50] shall continue until final disposition by the Supreme Court. Upon filing of a copy of an order of that Court denying the writ, the mandate shall issue forthwith.

[fol. 51] Clerk's certificate to foregoing transcript omitted in printing.

[fol. 52] SUPREME COURT OF THE UNITED STATES

ORDER ALLOWING CERTIORARI—Filed May 22, 1933

The petition herein for a writ of certiorari to the United States Circuit Court of Appeals for the Eighth Circuit is granted. And it is further ordered that the duly certified copy of the transcript of the proceedings below which accompanied the petition shall be treated as though filed in response to such writ.

Endorsed on cover: File No. 37,602. U. S. Circuit Court of Appeals, Eighth Circuit. Term No. 33. Thomas H. Welch, petitioner, vs. Commissioner of Internal Revenue. Petition for a writ of certiorari and exhibit thereto. Filed April 24, 1933. No. 33, O. T. 1933.

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CHARLES ELM

Supreme Court of the United States

OCTOBER TERM, 1932.

No. [redacted] 33

THOMAS H. WELCH,

Petitioner,

vs.

COMMISSIONER OF INTERNAL REVENUE,

Respondent.

PETITION FOR WRIT OF CERTIORARI TO THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE EIGHTH CIRCUIT AND BRIEF IN SUPPORT THEREOF.

THOMAS D. O'BRIEN,
ALEXANDER E. HORN,
EDWARD S. STRINGER,
Counsel for Petitioner,
St. Paul, Minn.

SUBJECT INDEX.

	Page
Petition for a writ of certiorari	1
A. Summary statement of matter involved	1
B. Reasons relied on for allowance of writ	2
C. Prayer for writ	3
Brief in support of petition for writ of certiorari	4
I. Opinions of Courts below	4
II. Jurisdiction	5
III. Statement of case	5
IV. Specification of errors	7
V. Argument	8
A. Conflict between Fifth and Eighth Circuits.	9
B. Decision of Court below incorrect	11
(1) Was this "business" expense	12
(2) Was this "necessary" expense	15
(3) Was this "ordinary" expense	16
Appendix	18

TABLE OF CASES CITED.

McCulloch vs. Maryland, 4 Wheaton, 315 15
American Rolling Mill Co. vs. Commissioner, 41 Fed. (2d), 314 13
Commissioner vs. People's-Pittsburgh Trust Co., 60 Fed. (2d), 187 ..... 13, 17
Corning Glass Works vs. Lucas, 37 Fed. (2d), 798..... 14
Harris vs. Lucas, 48 Fed. (2d), 187 .....3, 9, 10, 12
Kornhauser vs. United States, 276 U. S. 145 .....3, 13, 16

Lloyd vs. Commissioner, 55 Fed. (2d), 842 12
Lucas vs. Ox Fibre Brush Co., 281 U. S. 115 11
Mastin vs. Commissioner, 28 Fed. (2d), 748 14
Robinson vs. Commissioner, 53 Fed. (2d), 810 16
Welch vs. Commissioner, —— Fed. (2d), —— (March 24, 1933) 3, 4, 7, 10, 12

BOARD OF TAX APPEALS CASES CITED.

Dickinson vs. Commissioner, 8 B. T. A. 722 14
Hibbard, Spencer, Bartlett & Co. vs. Commissioner, 5 B. T. A. 464 14
Holt-Granite Mills Co. Appeal, 1 B. T. A. 1246 14
Hirsch-Weis Manufacturing Co. vs. Commissioner, 14 B. T. A. 796 14
Louisiana Jockey Club vs. Commissioner, 13 B. T. A. 752 14
McQuade's Appeal, 4 B. T. A. 837 14
Pierce vs. Commissioner, 18 B. T. A. 447 14
Poinsett Mills' Appeal, 1 B. T. A. 6 14
Superior Pocahontas Coal Co. vs. Commissioner, 7 B. T. A. 380 14
Welch vs. Commissioner, 25 B. T. A. 117 ..... 4, 6, 7, 12
Yamhill Electric Co. vs. Commissioner, 20 B. T. A. 1232. 14

TABLE OF STATUTES CITED.

Section 240, Judicial Code, as amended by Act of February 13, 1925 (43 Stat. L. 938, Section 347, Title 28, U. S. C.) 5
Section 214 (a) (1), Revenue Act of 1924 ..... 8, 18
Section 214 (a) (1), Revenue Act of 1926 ..... 8, 18
Section 23 (a), Revenue Act of 1928 ..... 8, 18

Supreme Court of the United States

OCTOBER TERM, 1932.

No. .....

THOMAS H. WELCH,

Petitioner,

vs.

COMMISSIONER OF INTERNAL REVENUE,

Respondent.

PETITION FOR WRIT OF CERTIORARI TO THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE EIGHTH CIRCUIT.

MAY IT PLEASE THE COURT:

The petition of Thomas H. Welch respectfully shows:

A.

SUMMARY STATEMENT OF MATTER INVOLVED.

Petitioner was a stockholder and managing officer of E. L. Welch Company. This corporation was adjudged a bankrupt in 1922, and in due course discharged. The business of the corporation had been handling grain on commission. In 1924,

petitioner entered the same line of business on his own account, dealing with the customers of the old corporation. In order to re-establish his credit, which had been damaged by the failure of the corporation, and to build up his business, petitioner, in each of the taxable years 1924 to 1928, inclusive, made payments to creditors of E. L. Welch Company of all or a part of their claims. By so doing, he was able to do a substantial business during these years, upon which the Government has been paid a tax. Each year petitioner claimed as a deduction for income tax purposes as one of his "ordinary and necessary expenses" in carrying on his business, the amounts paid during such year to the creditors of the old corporation.

The Commission disallowed the deductions, the Board of Tax Appeals sustained him, and the Circuit Court of Appeals for the Eighth Circuit sustained the Board of Tax Appeals.

The sole question involved is one of law, i. e., whether such payments to creditors of E. L. Welch Company, under such circumstances, were proper deductions for income tax purposes as "ordinary and necessary expenses" of petitioner's business.

B.

REASONS RELIED ON FOR THE ALLOWANCE OF THE WRIT.

I.

Because the decision of the Circuit Court of Appeals is in direct conflict with the decision of the Circuit Court of Appeals for the Fifth Circuit on the same matter in *Harris vs. Lucas*, 48 Fed. (2nd), 187.

II.

Because the Circuit Court of Appeals decided an important question of Federal law which has never been specifically settled by this Court.

III.

Because the Circuit Court of Appeals decided said question erroneously and in a way in conflict with the apparent view of this Court in *Kornhauser vs. United States*, 276 U. S. 145.

C.

PRAYER FOR WRIT.

WHEREFORE, petitioner prays that a writ of certiorari be issued by this Court, directed to the United States Circuit Court of Appeals for the Eighth Circuit, commanding that Court to certify to this Court, for its review, a transcript of the record in case numbered and entitled on its docket No. 9585, *Thomas H. Welch*, Petitioner, vs. *Commissioner of Internal Revenue*, Respondent, and that said judgment of the Circuit Court of Appeals be reversed, and that petitioner have such other relief as may be proper.

Respectfully submitted,

THOMAS D. O'BRIEN,
ALEXANDER E. HORN,
EDWARD S. STRINGER,
Counsel for Petitioner,
St. Paul, Minn.

Supreme Court of the United States

OCTOBER TERM, 1932.

No. .....

THOMAS H. WELCH,

Petitioner,

vs.

COMMISSIONER OF INTERNAL REVENUE,

Respondent.

BRIEF IN SUPPORT OF PETITION FOR WRIT OF CERTIORARI.

I.

THE OPINIONS OF THE COURTS BELOW.

The opinion of the Board of Tax Appeals (R. 21-24) is dated January 8, 1932, and is reported in *Welch vs. Commissioner of Internal Revenue,* 25 B. T. A. 117. The opinion of the Circuit Court of Appeals for the Eighth Circuit is dated March 24, 1933 (R. 39-40), and is not yet reported, *Welch vs. Commissioner of Internal Revenue,* —— Fed. (2nd), ——.

II.

(1) The jurisdiction of this Court is based upon Section 240 of the Judicial Code of 1911, as amended by Act of February 13, 1925 (43 Stats. L. 938, Section 347, Title 28, United States Code).

(2) The date of the judgment sought to be reviewed is March 24, 1933 (R. 41).

(3) Nature of case and rulings below.

(a) The Board of Tax Appeals held that payments made by petitioner to creditors of a corporation of which he had been an officer and stockholder, which debts had been discharged by bankruptcy prior to their payment, were not "ordinary and necessary expenses" of petitioner's business (R. 21-24).

(b) The Circuit Court of Appeals sustained the Board of Tax Appeals in so holding, and dismissed the petition for review (R. 39-41).

III.

STATEMENT OF CASE.

Petitioner had been a managing officer and stockholder of a corporation engaged in handling grain on commission. He and his father were the sole active managers, and, while petitioner's own stockholdings were relatively small, his father owned the entire balance of the stock, and by reason of the name of the corporation (E. L. Welch Company) it was closely associated with petitioner in the public mind. Petitioner was the active outside man who made all the contacts with the customers, and attended to the grading and sale of the grain (R. 30-31).

In 1922, this corporation became involved, was adjudged a bankrupt, and in due course discharged (R. 31).

Petitioner, about the same time, was likewise adjudged a bankrupt personally, and discharged (R. 31).

In 1924, petitioner entered on his own account in the same line of business that his corporation had formerly transacted, i. e., handling grain on commission. He dealt with the old customers of the corporation, many of whom were his personal friends, and who had become customers of the corporation because of petitioner's connection with it (R. 31-34).

The Board of Tax Appeals found:

> "In order to re-establish his standing and credit, and to revive new business contacts with former customers of the E. L. Welch Company, the petitioner determined, as far as he was able, to reimburse certain creditors of the E. L. Welch Company" (R. 22).

Beginning in 1924, and continuing until 1928, he made substantial payments to the creditors of the corporation out of the earnings of his business (R. 31-33).

The Commissioner, on audit of his income tax returns, disallowed these payments to the creditors of the corporation as deductions, and assessed deficiencies for each of said years in the aggregate amount of Three Thousand Seventy-two and 96/100 Dollars ($3,072.96) on account thereof (R. 6-7, 10-14, 16-20). The Board of Tax Appeals sustained the Commissioner in the assessment of these deficiencies and the disallowance of these deductions (R. 21-25), and the Circuit Court of Appeals sustained the Board of Tax Appeals, dismissing the petition for review (R. 39-41).

It should be noted, however, that there was a complete lack of agreement as to the reason for the denial of these deductions.

The Commissioner ruled that they were "capital expenditures", and not expenses at all (R. 11).

This theory was, however, apparently (although not expressly) rejected by the Board of Tax Appeals. The reason of the Board of Tax Appeals is as follows:

> "If the payments relate at all to 'carrying on a trade or business' they still may not be allocated as expense of any particular year. Doubtless petitioner more quickly reestablished his standing and credit and built up his new business by reimbursing those who had lost money through a corporation dominated by him and his father, but we do not understand payments of such a nature to be ordinary and necessary business expenses" (R. 23).

The theory that these expenditures were not allocable to any particular year was rejected by the Circuit Court of Appeals, which said:

> "There may be room for argument and difference as to whether payments of this character, under the circumstances here, are 'necessary', or not. It would be rather clear that they would be helpful in a business way and that helpfulness might approach or reach necessity. However, we can see no possible basis upon which payments of this character can be treated as 'ordinary' expenses of his business * * *. In fact, they are very extraordinary * * * and not expenses of the business at all" (R. 40).

IV.

SPECIFICATION OF ERRORS.

The Circuit Court of Appeals erred in dismissing the petition for review and in sustaining the Board of Tax Appeals in

(1) Holding that there was a deficiency for each of the years 1924 to 1928, inclusive.

(2 Refusing to hold that the amounts paid by petitioner to the creditors of E. L. Welch Co[illegible]y were ordinary and necessary expenses in carrying on petitioner's business, and refusing to hold that such payments were proper deductions from income of said years.

V.

ARGUMENT.

The statutory provisions involved are Section 214 (a) (1) of the Revenue Acts of 1924 and 1926, and Section 23 (a) of the Revenue Act of 1928. These provisions of the statute are reproduced in full in the Appendix, page 18. These sections are all identical and provide that the taxpayer may have as a deduction from gross income "all the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business." As stated by both Courts below, the only question is whether these payments to the creditors of the corporation were necessary and ordinary expenses of petitioner's business.

While there is no express finding in either Court, it is entirely clear from the reading of the record (R. 33-34) that if these payments had not been made, there would have been substantially no income from which to have deducted them. In other words, these payments resulted in a substantial income for each of the taxable years, and a resulting tax to the Government.

A

THERE IS A DIRECT CONFLICT OF DECISION BETWEEN THE EIGHTH AND THE FIFTH CIRCUITS.

The Court below, the Circuit Court of Appeals for the Eighth Circuit, reached a conclusion diametrically opposed to that of the Circuit Court of Appeals for the Fifth Circuit in *Harris vs. Lucas*, 48 Fed. (2nd), 187. The Court below did not, however, concede that its conclusion was opposed to that in the Harris case. In fact, it said:

> "They (the payments) are unlike the payments in Harris vs. Lucas * * *".

An analysis of the two cases shows, however, that there is no possibility of reconciling them. If there is a distinction, there is no difference. In the case below, after the bankruptcy of the corporation and consequent cancellation of its debts, the petitioner personally went into business. In the Harris case, after the bankruptcy of the corporation and consequent cancellation of its debts (composition agreement), the corporation itself went into business. In each case, the party desiring to increase its business paid debts which then had no legal existence on account of the bankruptcy. Yet, the Eighth Circuit holds such payments not to be proper deductions, while the Fifth Circuit holds that they are.

Will the Court compare the two cases:

8th Circuit.

Welch vs. Commissioner, (R. 39-40).

"The question is whether these expenses are 'ordinary and necessary', within the meaning of the statute. Words used in a statute are to be taken in their usual, everyday meaning, and this is particularly true of revenue statutes (United States vs. Kirby Lumber Co., 284 U. S. 1, 3; Woolford Realty Co. vs. Rose, 286 U. S. 319). The deductible expenses must be both 'necessary' and 'ordinary' (Lloyd vs. Commissioner, 55 Fed. (2d) 842, 844, C. C. A. 7). There may be room for argument and difference as to whether payments of this character, under the circumstances here, are 'necessary', or not. It would be rather clear that they would be helpful in a business way and that helpfulness might approach or reach necessity. However, we can see no possible basis upon which payments of this character can be treated as 'ordinary' expenses of his business (Robinson vs. Commissioner, 53 Fed. (2d) 810, 811, C. C. A. 8, and see Lloyd vs. Commissioner, 55 Fed. (2d) 842, C. C. A. 7, and Hubinger vs. Commisioner, 36 Fed. (2d) 724, 726, C. C. A. 2). In fact, they are very extraordinary payments, and not expenses of the business at all. They are unlike the payments in Harris vs. Lucas, 48 Fed. (2d) 187, C. C. A. 5, but are voluntary payments similar to those treated in Robinson vs. Commissioner, 53 Fed. (2d) 810, 811, C. C. A. 8, and Mastin vs. Commissioner, 28 Fed. (2d) 748, 753, C. C. A. 8. While these payments are highly commendable from an ethical standpoint, we are bound by the law as written."

5th Circuit.

Harris vs. Lucas, 48 Fed. (2nd), 187.

"It is evident that the words 'ordinary' and 'necessary' in the statute are not used conjunctively, and are not to be construed as requiring that an expense of a business to be deductible must be both ordinary and necessary in a narrow, technical sense. On the contrary, it is clear that Congress intended the statute to be broadly construed to facilitate business generally, so that any necessary expense, not actually a capital investment, incurred in good faith in a particular business, is to be considered an ordinary expense of that business. This in effect is the construction given the statute by the Treasury Department and the Courts.

* * * * *

"Of course, each case depends for decision upon its own facts, and it would be impossible to formulate a uniform rule to govern all cases. Generally speaking, business men should be free to exercise their ingenuity in devising methods of increasing business. This redounds to the benefit of the government by creating more taxable income. Considering the above-stated examples, it would seem clear by analogy that petitioner was entitled to deduct the amounts paid to its former creditors. It was under no legal obligation to make the payments, and they were made entirely to promote the business by restoring its credit with the wholesalers from whom it purchased goods.

* * * * * *

"It is perfectly plain that the payments did not constitute capital investment. On the contrary, the business was deprived of cash assets, and nothing was added to its saleable value. The payments may be classed as advertising expenditures as they secured credit not only from those to whom made but from the trade in general. They might be classed as bonuses paid to secure credit * * *".

It is apparent that the two cases cannot be reconciled, and that the Court below "has rendered a decision in conflict with the decision of another Circuit Court of Appeals on the same matter" (paragraph b, Section 3, Rule 38, Rules of this Court).

Bearing in mind that decisions of the Board of Tax Appeals are subject to review by ten different Courts of Appeals, it is apparent how necessary uniformity of decision in internal revenue cases becomes. At the present time, if the taxpayer lives in the Eighth Circuit, the Board of Tax Appeals must decide one way; if, in the Fifth Circuit, another way, and if, in any other Circuit, it must guess until such time as that Circuit of Appeals has spoken. This Court should definitely determine the law applying to such situation.

B.

THE DECISION OF THE CIRCUIT COURT OF APPEALS BELOW WAS INCORRECT.

It will not, we think, be disputed as a general proposition that business men should have a free hand to adopt such means as will result in increased business and increased income, resulting in increased revenue to the Government, and that the Government should not exercise a supervisory power over the methods adopted, or determine after the event whether the course adopted was wise or unwise, advisable or inadvisable, prudent or imprudent, so long as no law is violated. It is the taxpayer, whose investment is at stake, who should determine ways and means and not the Government.

The theory of the Board of Tax Appeals that these expenditures were not deductible, because not capable of allocation to any particular year, is obviously unsound under *Lucas vs. Ox Fibre Brush Company*, 281 U. S. 115. The Circuit Court of

Appeals did not adopt the view of the Board of Tax Appeals in that respect.

Under the terms of the Revenue Act, in order that an expense be properly deductible from gross income, it must be

(1) an expense attributable to "business",

(2) a "necessary" expense,

and*

(3) an "ordinary" expense.

(1)

WAS THIS A BUSINESS EXPENSE?

It is difficult to add anything to what the Harris case says in demonstrating that it was a business expense. The effort here by petitioner was to build up his business. By certain judicious payments, he accomplished this. Reading between the lines, it is apparent that if these payments had not been made, petitioner would not have had any income or business to tax. The Board of Tax Appeals in this case said:

> "Doubtless petitioner more quickly re-established his standing and credit and built up his new business by reimbursing those who had lost money * * *" (R. 23).

The Circuit Court of Appeals below said:

> "It would be rather clear that they (the payments) would be helpful in a business way and that helpfulness might approach or reach necessity" (R. 40).

It is impossible to distinguish the Harris case. There, a corporation paid certain of its old debts, which it was not required

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*Harris vs. Lucas, supra, holds that the words "ordinary" and "necessary" are not used conjunctively, but, on the contrary, are used disjunctively, although Lloyd vs. Commissioner, 55 Fed. (2nd), 842, holds that deductible expenses must be both "ordinary" and "necessary". This holding, however, was purely dictum, as the case was decided on the proposition that the expense involved was not a business expense.

to pay, to build up its business; here, petitioner paid certain debts of a corporation, dominated by him, and closely associated with his name in the public mind, which debts he was not legally required to pay, to build up his business. Of what consequence was it whose debts they originally were? This distinction loses all cogency because payment could not be enforced in either case, but the payment in each case was in a sense voluntary, and made as a matter of good business. Both the Board of Tax Appeals and the Circuit Court of Appeals clearly demonstrate by their reasoning that these were business expenditures, although each Court eventually rejects that conclusion.

How much more clearly were these business expenses than those involved in *Kornhauser vs. United States*, 276 U. S. 145, where this Court held that attorney's fees incurred in an accounting suit brought by a former law partner were business expenses, saying:

> "An expenditure for the purpose of obtaining or retaining taxable income does not seem like a personal expenditure" (p. 149).

The payments here are certainly more clearly business expenditures than those involved in *Commissioner vs. People's-Pittsburgh Trust Co.*, 60 Fed. (2nd), 187 (Third Circuit), where it was held that attorney's fees expended in defending a criminal charge of making false income tax returns were business expenditures rather than personal expenditures.

The Court of Appeals for the Sixth Circuit, in *American Rolling Mills Co. vs. Commissioner*, 41 Fed. (2nd), 314, held that contributions in the sum of Three Hundred Sixty Thousand Dollars ($360,000.00) to various civic organizations (Boy Scouts, American Legion, Y. M. C. A., etc.) were business expenditures. Certainly, these expenditures were voluntary in the sense that they could not have been compelled. They were made as a matter of good business. The Court said:

"The contention overlooks the fact that the contribution was not a philanthropy, but was a business expenditure to be reflected in increased earnings."

In *Corning Glass Works vs. Lucas*, 37 Fed. (2nd), 798, certiorari denied, 281 U. S. 742 (Court of Appeals, District of Columbia), it was held that a contribution of Twenty-five Thousand Dollars ($25,000.00) to the building fund of a hospital was a business expense, properly deductible.

The Board of Tax Appeals has consistently held that any expenditure reasonably tending to promote the business, earnings or good will of an enterprise is deductible as a business expense.*

Mastin vs. Commissioner, 28 Fed. (2nd), 748 (Eighth Circuit), relied on by the Court below, is not in point. It merely holds that expenditures for advertising real estate owned by a corporation, of which the taxpayer was a stockholder, were not business expenses of the taxpayer, but his personal expenses. The reason is clear. The taxpayer was not making the payment to better his own business, but to better the corporation's business. Obviously, therefore, it was not a business expense of the taxpayer.

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*Tickets to entertainments purchased from customers to promote good will, **McQuade's Appeal**, 4 B. T. A. 837; the cost of operating a yacht for the purpose of inducing customers to visit the plant, **Dickinson vs. Commissioner**, 8 B. T. A. 722; amounts paid by a brokerage firm to secure evidence to suppress bucket shops, **Pierce vs. Commissioner**, 18 B. T. A. 447; contribution to repair and enlarge a church attended by employees, **Peinsett Mills' Appeal**, 1 B. T. A. 6; contribution for erection of a school attended by employees' children, **Holt-Granite Mills Company's Appeal**, 1 B. T. A. 1246; fund for pensioning employees, **Hibbard, Spencer, Bartlett & Co. vs. Commissioner**, 5 B. T. A. 464; contribution to Chamber of Commerce, **Hirsch-Weis Manufacturing Co. vs. Commissioner**, 14 B. T. A. 796; payment of a note by a Jockey Club, which it was not legally obligated to pay to avoid revocation of license, **Louisiana Jockey Club, Inc., vs. Commissioner**, 13 B. T. A. 752; contribution of $1000.00 to the rebuilding of a church attended by taxpayer's employees, **Superior Pocahontas Coal Co. vs. Commissioner**, 7 B. T. A. 330. A contribution to the endowment fund of a college which had for its purpose the continuation of the college, as an institution * * * financially able to purchase petitioners product, **Yamhill Electric Co. vs. Commissioner**, 20 B. T. A. 1232.

Lloyd vs. Commissioner, 55 Fed. (2nd), 842 (Seventh Circuit), merely holds that attorney's fees expended by a taxpayer in prosecuting a slander suit against one who has slandered him personally were personal and not business expenditures. This case is not in point.

(2)

WERE THE EXPENDITURES "NECESSARY"?

The Circuit Court of Appeals below expressed doubt on this point. It seems to have entertained the view that in order that an expenditure be "necessary", it must be *absolutely* necessary, i. e., no option but to make it. The cases already cited under the last heading demonstrate that this is not the correct definition of the word, but beyond all this, this Court, more than a century ago, in *McCulloch vs. Maryland*, 4 Wheaton, 315, defined the word "necessary", as used in Section 8 of Article 1 of the Constitution, as follows:

> 'Is it true, that this is the sense in which the word 'necessary' is always used? Does it always import an absolute physical necessity, so strong, that one thing to which another may be termed necessary, cannot exist without the other? We think it does not. If reference be had to its use, in the common affairs of the world, or in approved authors, we find that it frequently imports no more than that one thing is convenient, or useful, or essential to another. To employ the means necessary to an end, is generally understood as employing any means calculated to produce the end, and not as being confined to those single means, without which the end would be entirely unattainable."

The word "necessary" in the Revenue Act means no more than that the expenditure shall be reasonably helpful in a busi-

ness way. So construed, it is clear these expenditures were necessary.

Robinson vs. Commissioner, 53 Fed. (2nd), 810 (Eighth Circuit), relied on by the Court below, is in no sense a parallel case. All that was there held was that the taxpayer could not get credit for taxes paid on somebody else's property, and which the taxpayer was not legally obligated to pay. However, if this case means that a taxpayer cannot take credit for a business expense unless he is legally obligated and compelled to make it, it is contrary to the holdings of every other Circuit.

(3)

WERE THE EXPENDITURES "ORDINARY"?

The Circuit Court of Appeals below says:

> "* * * we can see no possible basis upon which payments of this character can be treated as 'ordinary' expenses of his business * * *. In fact, they were very extraordinary payments * * *".

The Court was apparently of the view that the word "ordinary", as used in the statute, was synonymous with the words "usual" or "happening frequently" or "commonplace". That this is not the correct meaning of the word is made clear by *Kornhauser vs. United States,* 276 U. S. 145, where this Court said:

> "And it was an 'ordinary and necessary' expense, since a suit ordinarily and, as a general thing at least, necessarily requires the employment of counsel and payment of his charges."

It is clear, therefore, that it is not a question of whether an expense is a usual one, or commonly, or frequently incurred, but whether, *in the particular circumstances shown to have*

existed, it would be natural, or usual, or ordinary to have made the expenditure.

Referring again to *Commissioner vs. Peoples-Pittsburgh Trust Co.,* 60 Fed. (2nd), 187, it would, we think, be relatively uncommon and unusual for a man to hire a lawyer to defend him against the charge of making fraudulent tax returns. By this, we mean that it happens quite infrequently. Where, however, he is indicted for so doing, it is very usual and very common for him to employ a lawyer. In fact, it would be a most unusual case where he did not. Such attorney's fees were held "ordinary" expenses.

Granting that generally speaking it is unusual and even "extraordinary" for an individual to pay the debts of a corporation which have been discharged by bankruptcy, yet, if that individual were trying to continue in business and found that he could do no business and could get no credit (because the corporation was so closely linked with his name) unless the debts of the corporation were paid, it would, we think, be quite common, quite usual and quite "ordinary" for him to pay them.

In the sense attributed to the word by the Court below, none of the expenditures in any of the cases heretofore cited were "ordinary". In the broader sense, however, they were all "ordinary", and were so held. It is quite apparent that the Circuit Court of Appeals for the Eighth Circuit, contrary to the conclusions reached in other Circuits, has taken an unduly restricted view of what may be ordinary and necessary expenses.

The writ prayed for should be granted.

Respectfully submitted,

THOMAS D. O'BRIEN,
ALEXANDER E. HORN,
EDWARD S. STRINGER,
Counsel for Petitioner,
St. Paul, Minn.

APPENDIX.

Revenue Act of 1924, c. 234, 43 Stat. 253:

SEC. 214. (a) In computing net income there shall be allowed as deductions:

(1) All the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business, including a reasonable allowance for salaries or other compensation for personal services actually rendered; traveling expenses (including the entire amount expended for meals and lodging) while away from home in the pursuit of a trade or business; and rentals or other payments required to be made as a condition to the continued use or possession, for purposes of the trade or business, of property to which the taxpayer has not taken or is not taking title or in which he has no equity; * * *.

SEC. 215. (a) In computing net income no deduction shall in any case be allowed in respect of—

* * * * *

(2) Any amount paid out for new buildings or for permanent improvements or betterments made to increase the value of any property or estate;

(3) Any amount expended in restoring property or in making good the exhaustion thereof for which an allowance is or has been made; * * *

Section 214 (a) (1) and Section 215 (a) (2) and (3) of the Revenue Act of 1926 (c. 27, 44 Stat. 9), and Section 23 (a) and Section 24 (a) (2) and (3) of the Revenue Act of 1928 (c. 852, 45 Stat. 791) are identical.

FILE COPY

JUL 14 1933

IN THE

Supreme Court of the United States

OCTOBER TERM, 1933.

No. 33.

THOMAS H. WELCH,

Petitioner,

vs.

COMMISSIONER OF INTERNAL REVENUE,

Respondent.

On Writ of Certiorari to the United States Circuit Court of Appeals for the Eighth Circuit.

PETITIONER'S BRIEF.

THOMAS D. O'BRIEN
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SUBJECT INDEX.

	Page
I. Reference to opinions below	1
II. Statement and grounds of jurisdiction	2
III. Statement of case	2
IV. Specification of errors	5
V. Summary of Argument	5
VI. Argument	7
A. Conflict between Fifth and Eighth Circuits	7
B. Payments not capital expenditures	9
C. Payments are allocable to year when made	9
D. Decision of Court below incorrect	10
(1) These were "business" expenses	11
(2) These were "ordinary" expenses	15
(3) These were "necessary" expenses	16
Appendix	20

TABLE OF CASES CITED.

American Rolling Mill Co. vs. Commissioner, 41 Fed. (2d), 314 ..... 6, 13

Childers vs. Brown, 81 Ore. 1 17

Commissioner vs. People's-Pittsburgh Trust Co., 60 Fed. (2d), 187 ..... 6, 13, 15

Corning Glass Works vs. Lucas, 37 Fed. (2d), 798 .... 6, 13

Harris vs. Lucas, 48 Fed. (2d), 187 ..... 5, 6, 7, 11

Heinz vs. National Bank of Commerce in St. Louis, 237 Fed. 942 17

Kornhauser vs. United States, 276 U. S. 145 ..... 6, 12, 15

Lloyd vs. Commissioner, 55 Fed. (2d), 842 ..... 5, 11

Lucas vs. Ox Fibre Brush Co., 281 U. S. 115 ..... 5, 10
Madison Co. vs. Simpson, 173 Ark. 755 17
Mastin vs. Commissioner, 28 Fed. (2d), 748 14
McCulloch vs. Maryland, 4 Wheaton, 316 ..... 6, 16
Robinson vs. Commissioner, 53 Fed. (2d), 810 18
Tibbitts vs. Staude Manufacturing Co., 166 Minn. 139.. 17
Thrailkill vs. Crosbyton-Southplains R. Co., 246 Fed. 687 18
Welch vs. Commissioner, 63 Fed. (2d), 976 ..... 1, 8

BOARD OF TAX APPEALS CASES CITED.

Dickinson vs. Commissioner, 8 B. T. A. 722 14
Hibbard, Spencer, Bartlett & Co. vs. Commissioner, 5 B. T. A. 464 14
Holt-Granite Mills Co. Appeal, 1 B. T. A. 1246..... 14
Hirsch-Weis Manufacturing Co. vs. Commissioner, 14 B. T. A. 796 14
Louisiana Jockey Club vs. Commissioner, 13 B. T. A. 752 14
McQuade's Appeal, 4 B. T. A. 837 14
Pierce vs. Commissioner, 18 B. T. A. 447 14
Poinsett Mills' Appeal, 1 B. T. A. 6..... 14
Superior Pocahontas Coal Co. vs. Commissioner, 7 B. T. A. 380 14
Welch vs. Commissioner, 25 B. T. A. 117 1
Yamhill Electric Co. vs. Commissioner, 20 B. T. A. 1232. 14

TABLE OF STATUTES CITED.

Section 240, Judicial Code, as amended by Act of February 13, 1925 (43 Stat. L. 938, Section 347, Title 28, U. S. C.) 2
Section 214 (a) (1), Revenue Act of 1924 2
Section 214 (a) (1), Revenue Act of 1926 2
Section 23 (a), Revenue Act of 1928 2

TEXT BOOKS CITED.

Words and Phrases, Vol. 5, page 4705 18
Words and Phrases (2nd Series), Vol. 3, page 535 18
Words and Phrases (3rd Series), Vol. 5, page 339 18
Bouvier's Law Dictionary (Rawle's 3rd Revision), Vol. 3, page 2310 18

IN THE

Supreme Court of the United States

OCTOBER TERM, 1933.

No. 33.

THOMAS H. WELCH,

Petitioner,

vs.

COMMISSIONER OF INTERNAL REVENUE,

Respondent.

On Writ of Certiorari to the United States Circuit Court of Appeals for the Eighth Circuit.

PETITIONER'S BRIEF.

I.

REFERENCE TO OPINIONS BELOW.

Welch vs. Commissioner of Internal Revenue, 25 B. T. A. 117 (R. 19-22), January 8, 1932.

Welch vs. Commissioner of Internal Revenue, 63 Fed. (2nd) 976 (R. 34-36), March 24, 1933.

II.

STATEMENT AND GROUNDS OF JURISDICTION.

Jurisdiction of this Court rests on its order of May 22, 1933 (R. 38), granting a writ of certiorari under Section 240, Judicial Code of 1911, as amended by Act of February 13, 1925 (43 Stat. L. 938, Sect. 347, Title 28, U. S. Code).

III.

STATEMENT OF CASE.

The sole question involved is the correctness of the disallowance as deductions for income tax purposes of certain payments made by petitioner in each of the taxable years. If these payments were not proper deductions, the decision below was correct. The specific question is whether these payments were deductible from petitioner's gross income as "ordinary and necessary expenses paid or incurred during the taxable year in carrying on" petitioner's business.

Revenue Act of 1924, Chapter 234, Section 214 (a) (1), 43 Stat. L. 253.

Revenue Act of 1926, Chapter 27, Section 214 (a) (1), 44 Stat. L. 9.

Revenue Act of 1928, Chapter 852, Section 23 (a), 45 Stat. L. 791.

See appendix, page 20, for the full wording of the statutes.

Petitioner had been a managing officer and stockholder of a corporation engaged in handling grain on commission. He and his father were the sole active managers, and, while petitioner's own stockholdings were relatively small, his father owned the entire balance of the stock, and by reason of the name

of the corporation (E. L. Welch Company) it was closely associated with petitioner in the public mind. Petitioner was the active outside man who made all the contacts with the customers, and attended to the grading and sale of the grain (R. 28-29).

In 1922, this corporation became involved, was adjudged a bankrupt, and in due course discharged (R. 29).

Petitioner, about the same time, was likewise adjudged a bankrupt personally, and discharged (R. 28).

In 1924, petitioner entered on his own account in the same line of business that his corporation had formerly transacted, i. e., handling grain on commission. He dealt with the old customers of the corporation, many of whom were his personal friends, and who had become customers of the corporation because of petitioner's connection with it (R. 30-31).

For obvious reasons, the existence of these old debts of the corporation, unenforcible though they were, constituted a substantial obstacle to petitioner in the transaction of his business.

The Board of Tax Appeals found:

> "In order to re-establish his standing and credit, and to revive new business contacts with former customers of the E. L. Welch Company, the petitioner determined, as far as he was able, to reimburse certain creditors of the E. L. Welch Company" (R. 20).

Beginning in 1924, and continuing until 1928, he made substantial payments to the creditors of the corporation out of the earnings of his business (R. 29-31).

The Commissioner, on audit of his income tax returns, disallowed these payments to the creditors of the corporation as deductions, and assessed deficiencies for each of said years in the aggregate amount of Three Thousand Seventy-two and

96/100 Dollars ($3,072.96) on account thereof* (R. 5-6, 8-12, 14-18). The Board of Tax Appeals sustained the Commissioner in the assessment of these deficiencies and the disallowance of these deductions (R. 19-22), and the Circuit Court of Appeals sustained the Board of Tax Appeals, dismissing the petition for review (R. 34-36).

However, there was a complete lack of agreement as to the reason for the denial of these deductions.

The Commissioner ruled that they were "capital expenditures", and not expenses at all (R. 10).

This theory was, however, apparently (although not expressly) rejected by the Board of Tax Appeals. The reason of the Board of Tax Appeals is as follows:

> "If the payments relate at all to 'carrying on a trade or business' they still may not be allocated as expense of any particular year. Doubtless petitioner more quickly reestablished his standing and credit and built up his new business by reimbursing those who had lost money through a corporation dominated by him and his father, but we do not understand payments of such a nature to be ordinary and necessary business expenses" (R. 21).

The theory that these expenditures were not allocable to any particular year was apparently not looked upon with favor by the Circuit Court of Appeals, which, while not expressly rejecting the idea, said:

> "There may be room for argument and difference as to whether payments of this character, under the circumstances here, are 'necessary', or not. It would be rather clear that they would be helpful in a business way and that helpfulness might approach or reach necessity. How-

---

*On his income tax returns for 1924, 1925, and 1926 petitioner reported only the amounts he earned over and above the payments to creditors of the corporation. On his income tax returns for 1927 and 1928 he reported his total earnings and deducted the payments to creditors. The Commissioner added to income the payments for 1924, 1925, and 1926 and disallowed the deductions taken in 1927 and 1928. (R. 21).

ever, we can see no possible basis upon which payments of this character can be treated as 'ordinary' expenses of his business * * *. In fact, they are very extraordinary * * * and not expenses of the business at all" (R. 35).

IV.

SPECIFICATION OF ERRORS.

The Circuit Court of Appeals erred in dismissing the petition for review and in sustaining the Board of Tax Appeals in

(1) Holding that there was a deficiency for each of the years 1924 to 1928, inclusive (R. 34-36).

(2) Refusing to hold that the amounts paid by petitioner to the creditors of E. L. Welch Company were ordinary and necessary expenses in carrying on petitioner's business, and refusing to hold that such payments were proper deductions from income for said years (R. 34-36).

V.

SUMMARY OF ARGUMENT.

A. There is a direct conflict on this question between the Circuit Court of Appeals for the Eighth Circuit and that of the Fifth Circuit. The latter Court in a case not distinguishable in principle from the case at bar, held that such payments were "ordinary and necessary expenses".

Harris vs. Lucas, 48 Fed. (2nd) 187.

B. These payments were not "capital expenditures".

Harris vs. Lucas, supra.

C. These payments are properly allocable to the year when made.

Lucas vs. Ox Fibre Brush Company, 281 U. S. 115.

D. Assuming that to be deductible a payment must be, not only a business expense, but must also be, in addition, both an ordinary and necessary expense, although there is substantial authority to the contrary (Harris vs. Lucas, supra), yet these payments were all three.

(a) They were "business" expenses.

Kornhauser vs. United States, 276 U. S. 145.

Commissioner vs. People's-Pittsburgh Trust Co., 60 Fed. (2nd) 187.

American Rolling Mill Co. vs. Commissioner, 41 Fed. (2nd) 314.

Corning Glass Works vs. Lucas, 37 Fed. (2nd) 798.

Harris vs. Lucas, supra.

(b) They were "ordinary" expenses.

Kornhauser vs. United States, supra.

Commissioner vs. People's-Pittsburgh Trust Co., supra.

(c) They were "necessary" expenses.

Harris vs. Lucas, supra.

McCulloch vs. Maryland, 4 Wheaton, 316.

American Rolling Mill Co. vs. Commissioner, supra.

Corning Glass Works vs. Lucas, supra.

VI.

ARGUMENT.

The statutory provisions involved are Section 214 (a) (1) of the Revenue Acts of 1924 and 1926, and Section 23 (a) of the Revenue Act of 1928. These provisions of the statute are reproduced in full in the Appendix, page 20. These sections are all identical and provide that the taxpayer may have as a deduction from gross income "all the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business." As stated by both Courts below, the only question is whether these payments to the creditors of the corporation were necessary and ordinary expenses of petitioner's business.

While there is no express finding in either Court, it is entirely clear from the reading of the record (R. 31-32) that if these payments had not been made petitioner would have had substantially no income. In other words, these payments resulted in a substantial income for each of the taxable years, and a resulting tax to the Government.

A.

Conflict Between Eighth and Fifth Circuits.

While the Court below asserted in its opinion (R. 35) that the facts in the case at bar were to be distinguished from those in *Harris vs. Lucas*, 48 Fed. (2nd), 187 (5 C. C. A.), saying:

> "They (the payments) are unlike the payments in Harris vs. Lucas."

it is apparent there is no distinction in principle between the cases. They are clearly opposed to each other, and it is impossible to reconcile them.

In the case below, after the bankruptcy of the corporation and consequent cancellation of its debts, the petitioner personally went into business. In the Harris case, after the bankruptcy of the corporation and consequent cancellation of its debts (composition agreement), the corporation itself went into business. In each case, the party desiring to increase its business paid debts which then had no legal existence on account of the bankruptcy. Yet, the Eighth Circuit holds such payments not to be proper deductions, while the Fifth Circuit holds that they are.

A comparison of the two cases is of interest.

8th Circuit.

Welch vs. Commissioner (R. 34-36), 63 Fed. (2nd), 976.

"The question is whether these expenses are 'ordinary and necessary', within the meaning of the statute. Words used in a statute are to be taken in their usual, everyday meaning, and this is particularly true of revenue statutes (United States vs. Kirby Lumber Co., 284 U. S. 1, 3; Woolford Realty Co. vs. Rose, 286 U. S. 319). The deductible expenses must be both 'necessary' and 'ordinary' (Lloyd vs. Commissioner, 55 Fed. (2d) 842, 844, C. C. A. 7). There may be room for argument and difference as to whether payments of this character, under the circumstances here, are 'necessary', or not. It would be rather clear that they would be helpful in a business way and that helpfulness might approach or reach necessity. However, we can see no possible basis upon which payments of this character can be treated as 'ordinary' expenses of his business (Robinson vs. Commissioner, 53 Fed. (2d) 810, 811, C. C. A. 8, and see Lloyd vs. Commissioner, 55 Fed. (2d) 842, C. C. A. 7, and Hubinger vs. Commissioner, 36 Fed. (2d) 724, 726, C. C. A. 2). In fact, they are very extraordinary payments, and not expenses of the business at all. They are unlike the payments in

5th Circuit.

Harris vs. Lucas, 48 Fed. (2nd), 187.

"It is evident that the words 'ordinary' and 'necessary' in the statute are not used conjunctively, and are not to be construed as requiring that an expense of a business to be deductible must be both ordinary and necessary in a narrow, technical sense. On the contrary, it is clear that Congress intended the statute to be broadly construed to facilitate business generally, so that any necessary expense, not actually a capital investment, incurred in good faith in a particular business, is to be considered an ordinary expense of that business. This in effect is the construction given the statute by the Treasury Department and the Courts.

* * * * *

"Of course, each case depends for decision upon its own facts, and it would be impossible to formulate a uniform rule to govern all cases. Generally speaking, business men should be free to exercise their ingenuity in devising methods of increasing business. This redounds to the benefit of the government by creating more taxable income. Considering the above-stated examples, it would seem clear by analogy that petitioner was entitled to deduct the amounts paid to its former creditors. It was under no legal obligation to

Harris vs. Lucas, 48 Fed. (2d) 187, C. C. A. 5, but are voluntary payments similar to those treated in Robinson vs. Commissioner, 58 Fed. (2d) 810, 811, C. C. A. 8, and Mastin vs. Commissioner, 28 Fed. (2d) 748, 753, C. C. A. 8. While these payments are highly commendable from an ethical standpoint, we are bound by the law as written."

make the payments, and they were made entirely to promote the business by restoring its credit with the wholesalers from whom it purchased goods.

* * * * *

B.

THESE PAYMENTS WERE NOT "CAPITAL EXPENDITURES".

Nothing can be added to what was said in Harris vs. Lucas, supra, to demonstrate the fallacy of the reasoning of the Commissioner (with which neither the Board of Tax Appeals nor the Circuit Court of Appeals agreed) that these payments are "capital expenditures". There, the Court said:

> "It is perfectly plain that the payments did not constitute capital investment. On the contrary, the business was deprived of cash assets, and nothing was added to its saleable value. The payments may be classed as advertising expenditures as they secured credit not only from those to whom made but from the trade in general. They might be classed as bonuses paid to secure credit * * *".

C.

THE PAYMENTS WERE PROPERLY ALLOCABLE TO THE YEAR WHEN MADE.

The findings of the Board of Tax Appeals show exactly what payments were made each year and claimed as a deduction for that particular year. The law provides that such expenses are deductible when "paid or incurred during the taxable year". It is, therefore, difficult to appreciate the reasoning of the Board of Tax Appeals (with which the Circuit Court of Appeals did not agree) that the payments were incapable of

allocation to any particular year. The matter would seem entirely disposed of by the case of *Lucas vs. Ox Fibre Brush Company*, 281 U. S. 115, where the Court said:

> "In the present instance, the expense could not be attributed to earlier years, for it was neither paid nor incurred in those years. There was no earlier accrual of liability. It was deductible in the year 1920 or not at all. Being deductible as a reasonable payment, there was no authority vested in the Commissioner to disregard the actual transaction and to readjust the income on another basis which did not respond to the facts."

D.

The Court of Appeals Below Reached an Erroneous Conclusion in Holding that these Payments Were Neither "Business" Expenses Nor "Ordinary" Expenses, and in Expressing Doubt as to Whether They Were "Necessary" Expenses.

It will not, we think, be disputed as a general proposition that business men should have a free hand to adopt such means as will result in increased business and increased income, resulting in increased revenue to the Government, and that the Government should not exercise a supervisory power over the methods adopted, or determine after the event whether the course adopted was wise or unwise, advisable or inadvisable, prudent or imprudent, so long as no law is violated. It is the taxpayer, whose investment is at stake, who should determine ways and means and not the Government.

Conceding for argument that under the terms of the Revenue Act, in order that an expense be properly deductible from gross income, it must be (1) an expense attributable to business; (2) an ordinary expense, and (3) a necessary expense,

although there is authority to the contrary,* it is apparent that these expenses meet all three tests.

These Were Business Expenses.

It is difficult to add anything to what was said in the Harris case in demonstrating that these payments were business expenses. The effort by petitioner was to build up his business. By certain judicious payments, he accomplished this. Reading between the lines, it is apparent that if these payments had not been made, petitioner would not have had any income or business to tax. The Board of Tax Appeals in this case said:

> "Doubtless petitioner more quickly re-established his standing and credit and built up his new business by reimbursing those who had lost money * * *" (R. 23).

The Circuit Court of Appeals below said:

> "It would be rather clear that they (the payments) would be helpful in a business way and that helpfulness might approach or reach necessity" (R. 40).

It is impossible to distinguish the Harris case which the Court below seems to recognize as good law. There, a corporation in order to build up its business paid certain of its old debts, which it was not required to pay, here, petitioner to build up his business paid certain debts of a corporation, dominated by him, and closely associated with his name in the public mind, which debts he was not legally required to pay. Of what consequence was it whose debts they originally were?

The Circuit Court of Appeals did not attempt to point out any distinction, beyond the bare statement that there was one.

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*Harris vs. Lucas, supra, holds that the words "ordinary" and "necessary" are not used conjunctively, but, on the contrary, are used disjunctively, although Lloyd vs. Commissioner, 55 Fed. (2nd), 842, holds that deductible expenses must be both "ordinary" and "necessary". This holding, however, was purely dictum, as the case was decided on the proposition that the expense involved was not a business expense.

The Government in its brief opposing certiorari (page 7) makes this feeble attempt to distinguish the cases:

> "The two cases are distinguishable. In the A. Harris & Co. case the payments were made by the party which had incurred the claims paid. In the instant case the payments were made by one who never had been liable for the debt and there was no such intimate relationship between petitioner's business and the payments made here as there was in the Harris case, where the payment was necessary to obtain credit for the same enterprise which had previously proved to be an unsafe credit risk."

This argument loses all cogency since payment could not be enforced in either case, but in each case was in a sense voluntary, and made as a matter of good business. Both the Board of Tax Appeals and the Circuit Court of Appeals clearly demonstrate by their reasoning that these were business expenditures, although each Court eventually rejects that conclusion.

How much more clearly were these business expenses than those involved in *Kornhauser vs. United States*, 276 U. S. 145, where this Court held that attorney's fees incurred in an accounting suit brought by a former law partner were business expenses, saying:

> "An expenditure for the purpose of obtaining or retaining taxable income does not seem like a personal expenditure" (p. 149).

The brief of the Government opposing certiorari (page 6) contains this statement:

> "The regulations of the Treasury Department under the Revenue Acts of 1924, 1926, and 1928 (infra, pp. 9-10) limit deductions under the provision for 'ordinary and necessary expenses' in carrying on a 'trade or business', to the current operating expenses *incurred in producing the income*" (Italics ours).

What benefit counsel seek from this suggestion is not apparent. We have no quarrel with it. On the contrary, we acquiesce in it. If these payments were not made for the purpose of "producing the income", we do not know what they were made for. Both the Board of Tax Appeals and the Circuit Court of Appeals stated clearly in their respective opinions that, not only were these payments made for the purpose of producing income, but that was the actual result (R. 21, 35). See quotations from these opinions on page 11 of this brief. Our whole case is founded on the proposition that these payments were made as a matter of good business for the purpose of producing income.

The payments here are certainly more clearly business expenditures than those involved in *Commissioner vs. People's-Pittsburgh Trust Co.*, 60 Fed. (2nd), 187 (Third Circuit), where it was held that attorney's fees expended in defending a criminal charge of making false income tax returns were business expenditures rather than personal expenditures.

The Court of Appeals for the Sixth Circuit, in *American Rolling Mill Co. vs. Commissioner*, 41 Fed. (2nd), 314, held that contributions in the sum of Three Hundred Sixty Thousand Dollars ($360,000.00) to various civic organizations (Boy Scouts, American Legion, Y. M. C. A., etc.) were business expenditures. Certainly, these expenditures were voluntary in the sense that they could not have been compelled. They were made as a matter of good business. The Court said:

> "The contention overlooks the fact that the contribution was not a philanthropy, but was a business expenditure to be reflected in increased earnings."

In *Corning Glass Works vs. Lucas*, 37 Fed. (2nd), 798, certiorari denied, 281 U. S. 742 (Court of Appeals, District of Columbia), it was held that a contribution of Twenty-five

Thousand Dollars ($25,000.00) to the building fund of a hospital was a business expense, properly deductible.

The Board of Tax Appeals has consistently held that any expenditure reasonably tending to promote the business, earnings or good will of an enterprise is deductible as a business expense.*

Mastin vs. Commissioner, 28 Fed. (2nd), 748 (Eighth Circuit), relied on by the Court below, is not in point. It merely holds that expenditures for advertising real estate owned by a corporation, of which the taxpayer was a stockholder, were not business expenses of the taxpayer, but his personal expenses. The reason is clear. The taxpayer was not making the payment to better his own business, but to better the corporation's business. Obviously, therefore, it was not a business expense of the taxpayer. The resulting benefit to the stockholder would be indirect, here while the claim paid was against the corporation, the benefit denied was direct to the petitioner who made the payments.

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*Tickets to entertainments purchased from customers to promote good will, **McQuade's Appeal**, 4 B. T. A. 837; the cost of operating a yacht for the purpose of inducing customers to visit the plant, **Dickinson vs. Commissioner**, 8 B. T. A. 722; amounts paid by a brokerage firm to secure evidence to suppress bucket shops, **Pierce vs. Commissioner**, 18 B. T. A. 447; contribution to repair and enlarge a church attended by employees, **Poinsett Mills' Appeal**, 1 B. T. A. 6; contribution for erection of a school attended by employees' children, **Holt-Granite Mills Company's Appeal**, 1 B. T. A. 1246; fund for pensioning employees, **Hibbard, Spencer, Bartlett & Co. vs. Commissioner**, 5 B. T. A. 464; contribution to Chamber of Commerce, **Hirsch-Weis Manufacturing Co. vs. Commissioner**, 14 B. T. A. 796; payment of a note by a Jockey Club, which it was not legally obligated to pay to avoid revocation of license, **Louisiana Jockey Club, Inc., vs. Commissioner**, 13 B. T. A. 752; contribution of $1000.00 to the rebuilding of a church attended by taxpayer's employees, **Superior Pocahontas Coal Co. vs. Commissioner**, 7 B. T. A. 380. A contribution to the endowment fund of a college which had for its purpose the continuation of the college, as an institution * * * financially able to purchase petitioners product, **Yamhill Electric Co. vs. Commissioner**, 20 B. T. A. 1232.

2.

THESE WERE "ORDINARY" EXPENSES.

The Circuit Court of Appeals below said:

> "* * * we can see no possible basis upon which payments of this character can be treated as 'ordinary' expenses of his business * * *. In fact, they were very extraordinary payments * * *". (R. 35).

The Court was apparently of the view that the word "ordinary", as used in the statute, was synonymous with the words "common" or "usual" or "often recurring". This is the view taken by the Government in its brief opposing certiorari (page 5). That this is not the correct meaning of the word is made clear by *Kornhauser vs. United States*, 276 U. S. 145, where this Court said:

> "And it was an 'ordinary and necessary' expense, since a suit ordinarily and, as a general thing at least, necessarily requires the employment of counsel and payment of his charges."

It is clear, therefore, that it is not a question of whether an expense is a "usual" one, or a "common" one, or one "frequently recurring," but whether, *in the particular circumstances shown to have existed*, it would be common, or usual, or "ordinary" to have made the expenditure.

Referring again to *Commissioner vs. People's-Pittsburgh Trust Co.*, 60 Fed. (2nd), 187, it would, we think, be relatively uncommon and unusual and not often recurring for a man to employ a lawyer to defend him against the charge of making fraudulent tax returns. By this, we mean that it happens quite infrequently. Where, however, he is indicted for so doing, it is very usual and very common for him to employ a lawyer. In

fact, it would be a most unusual case where he did not. Such attorney's fees were held "ordinary" expenses.

Granting that generally speaking it is unusual and even "extraordinary" for an individual to pay the debts of a corporation which have been discharged by bankruptcy, yet, if that individual were trying to continue in business and found that he could do no business and could get no credit (because the corporation was so closely linked with his name) unless the debts of the corporation were paid, it would, we think, be quite common, quite usual and quite "ordinary" for him to pay them.

In the sense attributed to the word by the Court below, none of the expenditures in any of the cases heretofore cited were "ordinary". In the broader sense, however, they were all "ordinary", and were so held. It is quite apparent that the Circuit Court of Appeals for the Eighth Circuit, contrary to the conclusions reached in other Circuits, has taken an unduly restricted view of what may be ordinary expenses.

3.

THESE WERE "NECESSARY" EXPENSES.

The Circuit Court of Appeals below expressed doubt on this point. It seems to have entertained the view that in order that an expenditure be "necessary", it must be *absolutely* necessary, i. e., no option but to make it. The cases already cited under the last heading demonstrate that this is not the correct definition of the word, but beyond all this, this Court, more than a century ago, in *McCulloch vs. Maryland,* 4 Wheaton, 316, defined the word "necessary", as used in Section 8 of Article 1 of the Constitution, as follows:

> "Is it true, that this is the sense in which the word 'necessary' is always used? Does it always import an absolute

physical necessity, so strong, that one thing to which another may be termed necessary, cannot exist without the other? We think it does not. If reference be had to its use, in the common affairs of the world, or in approved authors, we find that it frequently imports no more than that one thing is convenient, or useful, or essential to another. To employ the means necessary to an end, is generally understood as employing any means calculated to produce the end, and not as being confined to those single means, without which the end would be entirely unattainable."

While in some instances where the context demands it, the word "necessary" in a statute may be construed to mean "absolutely necessary", yet in the majority of cases the word has been held to be synonymous with "convenient", or "suitable".

In a statute exempting from execution any vehicle "necessary" to enable a person to carry on his business, the word was held to signify "reasonably necessary", or "convenient", or "suitable", and not to mean "indispensable", or "absolutely necessary".

Childers vs. Brown, 81 Oregon, 1.

In a statute permitting a Circuit Clerk to purchase "things necessary for his office", the word was held to mean "convenient, useful or appropriate", although not "essential".

Madison Co. vs. Simpson, 173 Arkansas, 755.

In a statute giving an injured employee additional compensation for re-education where such re-education was "necessary", the word was held, to mean not "indispensable", but merely that such re-education would tend to restore the injured man's earnings capacity.

Tibbitts vs. E. G. Staude Manufacturing Co., 166 Minn. 139.

When dealing with implied powers, the word "necessary" does not mean "indispensable".

Heinz vs. National Bank of Commerce in St. Louis, 237 Fed. 942 (8).

Thrailkill vs. Crosbyton-Southplains R. Co., 246 Fed. 687 (8).

Authorities to the same effect are legion. See

Words and Phrases, Vol. 5, page 4705.

Words and Phrases (2nd Series), Vol. 3, page 535.

Words and Phrases (3rd Series), Vol. 5, page 339.

Bouvier's Law Dictionary (Rawle's 3rd Revision), Vol. 3, page 2310.

Although the Government in its brief opposing certiorari (page 5) takes the view that the word "necessary" should be defined as "impossible to be otherwise, indispensable, requisite or essential" (quoting Webster's dictionary), it is quite apparrent that the word in the Revenue Act means no more than that the expenditure shall be reasonably helpful in a business way. So construed, it is clear these expenditures were necessary.

Robinson vs. Commissioner, 53 Fed. (2nd), 810 (Eighth Circuit), relied on by the Court below, is in no sense a parallel case. All that was there held was that the taxpayer could not get credit for taxes paid on somebody else's property, and which the taxpayer was not legally obligated to pay. However, if this case means that a taxpayer cannot take credit for a business expense unless he is legally obligated and compelled to make it, it is contrary to the holdings of every other Circuit.

The judgment of the Circuit Court of Appeals should be reversed.

Respectfully submitted,

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APPENDIX.

Revenue Act of 1924, c. 234, 43 Stat. 253:

SEC. 214. (a) In computing net income there shall be allowed as deductions:

(1) All the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business, including a reasonable allowance for salaries or other compensation for personal services actually rendered; traveling expenses (including the entire amount expended for meals and lodging) while away from home in the pursuit of a trade or business; and rentals or other payments required to be made as a condition to the continued use or possession, for purposes of the trade or business, of property to which the taxpayer has not taken or is not taking title or in which he has no equity; * * *

SEC. 215. (a) In computing net income no deduction shall in any case be allowed in respect of—

* * * * * *

(2) Any amount paid out for new buildings or for permanent improvements or betterments made to increase the value of any property or estate;

(3) Any amount expended in restoring property or in making good the exhaustion thereof for which an allowance is or has been made; * * *

Section 214 (a) (1) and Section 215 (a) (2) and (3) of the Revenue Act of 1926 (c. 27, 44 Stat. 9), and Section 23 (a) and Section 24 (a) (2) and (3) of the Revenue Act of 1928 (c. 852, 45 Stat. 791) are identical.

INDEX

	Page
Opinions below	1
Jurisdiction	1
Question presented	2
Statutes and regulations involved	2
Statement	2
Argument	4
Conclusion	8
Appendix	9–10

CITATIONS

Cases:	
Burnet v. *Guggenheim*, No. 283, October Term, 1932, decided February 6, 1933	7
Ellis v. *Burnet*, 50 F. (2d) 343	5
Harris, A., & Co. v. *Lucas*, 48 F. (2d) 187	7, 8
Hubinger v. *Commissioner*, 36 F. (2d) 724, certiorari denied, 281 U.S. 741	8
Lloyd v. *Commissioner*, 55 F. (2d) 842	5, 8
Massachusetts Mutual Life Insurance Co. v. *United States*, No. 322, October Term, 1933, decided February 6, 1933	7
Mastin v. *Commissioner*, 28 F. (2d) 748	6
National Piano Mfg. Co. v. *Burnet*, 50 F. (2d) 310	6
Parkersburg Iron & Steel Co. v. *Burnet*, 48 F. (2d) 163	8
Robinson v. *Commissioner*, 53 F. (2d) 810	6
Simmons Co. v. *Commissioner*, 33 F. (2d) 75, certiorari denied, 280 U.S. 588	5
Stephenson v. *Commissioner*, 43 F. (2d) 348	6
White v. *Commissioner*, 61 F. (2d) 726	5, 8
Statutes:	
Revenue Act of 1924, c. 234, 43 Stat. 253, 269:	
Sec. 214 (U.S.C., Title 26, Sec. 955)	9
Revenue Act of 1926, c. 27, 44 Stat. 9, 26, 28:	
Sec. 214 (U.S.C.App., Title 26, Sec. 955)	9
Sec. 215 (U.S.C.App., Title 26, Sec. 956)	9
Revenue Act of 1928, c. 852, 45 Stat. 791, 799:	
Sec. 23	9
Miscellaneous:	
Treasury Regulations 65, promulgated under the Revenue Act of 1924:	
Art. 24	9
Art. 101	9
Art. 112	10

In the Supreme Court of the United States

OCTOBER TERM, 1932

No. 905

THOMAS H. WELCH, PETITIONER

v.

DAVID BURNET, COMMISSIONER OF INTERNAL REVENUE

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE EIGHTH CIRCUIT

BRIEF FOR THE RESPONDENT IN OPPOSITION

OPINIONS BELOW

The opinion of the Board of Tax Appeals (R. 23–24) is reported in 25 B.T.A. 117. The opinion of the Circuit Court of Appeals (R. 38–40) is not yet reported.

JURISDICTION

The judgment of the Circuit Court of Appeals was entered March 24, 1933 (R. 40–41). The petition for writ of certiorari was filed April 24, 1933. The jurisdiction of this Court is invoked under Section 240 (a) of the Judicial Code, as amended by the Act of February 13, 1925.

QUESTION PRESENTED

Whether petitioner, having voluntarily paid claims against a bankrupt corporation with which he had been associated for which claims he was not legally liable, may deduct the amounts so paid as ordinary and necessary business expenses because these payments tended to strengthen his business standing and credit in the business in which he was then engaged.

STATUTES AND REGULATIONS INVOLVED

The applicable provisions of the statutes and regulations involved are set forth in the Appendix (*infra*, pp. 9, 10).

STATEMENT

The following is a summary of the facts found by the Board of Tax Appeals (R. 22–23):

During 1922 the petitioner was secretary of the E. L. Welch Company, a Minnesota corporation, engaged in the grain business. Except for ten shares of stock owned by him, all the stock of the E. L. Welch Company was owned by petitioner's father. For several years prior to 1922 taxpayer had been in close touch with the customers of E. L. Welch Company, having traveled through the territory in which it did business during three or four months each summer making and dealing with present and prospective customers. He took charge of all grain as it came in to Minneapolis and attended to its grading and sale. His father looked after the financial end of the business only.

On March 23, 1922, the E. L. Welch Company was adjudged an involuntary bankrupt, and the

petitioner was adjudged a voluntary bankrupt on August 5, 1922. Both the company and he were discharged from liability for debts. Shortly thereafter the petitioner entered into a contract with the Kellogg Company to purchase grain for it on a commission basis. In order to reestablish his standing and credit and to revive new business contacts with former customers of the E. L. Welch Company, the petitioner decided to reimburse certain creditors of the E. L. Welch Company as far as he was able. Beginning in 1924, he made small payments to all of the numerous creditors, except two, by a special check which bore the following indorsement:

> The payee of this check, by the endorsement hereof, accepts and agrees to apply the same on its claim against E. L. Welch Company, according to the terms of the letter of transmittal. It has nothing to do with present or future business relations with the maker of the check and is not to be considered as acknowledging any existing claim or renewing any barred claim against him.

From 1924 to 1928 petitioner earned commissions and made payments to reimburse creditors of the E. L. Welch Company as follows:

Year	Commissions	Credits of E. L. Welch Co.
1924	$18,038.20	$3,975.97
1925	21,377.07	11,988.20
1926	20,925.25	12,815.72
1927	22,110.61	7,379.72
1928	26,177.56	11,088.26

On his income-tax returns for 1924, 1925, and 1926 petitioner reported only the amount remaining from commissions earned after payments of the above amounts to creditors of the E. L. Welch Company. On his income-tax returns for 1927 and 1928 he reported the total commissions received and deducted the payments to creditors of the E. L. Welch Company.

The Commissioner added the payments for 1924, 1925, and 1926 to petitioner's income and disallowed the deductions taken in 1927 and 1928. The Board of Tax Appeals sustained this action (R. 24–25), and upon appeal the Circuit Court of Appeals affirmed (R. 40–41).

ARGUMENT

The petitioner contends that the amounts paid to the creditors of the bankrupt corporation were deductible, in computing his income taxes for the years in question, as ordinary and necessary expenses incurred in carrying on his individual business. It is submitted that these items do not come within the terms of Section 214 (a) (1) of the Revenue Act of 1924 and the similar provisions of the 1926 and 1928 Acts (*infra*, p. 9) which allow the deduction of "all the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business * * *."

The claims upon which the payments were made were not legal obligations of petitioner, and they did not directly arise out of the conduct of his own business. They were made because it was believed that, by enhancing petitioner's financial and business standing among former customers of the bankrupt corporation with which he had been associated, his

individual business would be benefited. Such an indirect relation between the payments and the business is not sufficient to justify the deduction. See *Lloyd* v. *Commissioner*, 55 F. (2d) 842 (C.C.A. 7th); *Ellis* v. *Burnet*, 50 F. (2d) 343 (App. D.C.). The words of the statute taken in their ordinary meaning preclude the allowance of the payments as *ordinary* and *necessary* business expenses. Webster's dictionary defines "ordinary" as "common, usual, often recurring," and it defines "necessary" as "impossible to be otherwise, indispensable, requisite or essential." The expenditures here do not come within either of these definitions. The deductions claimed must be denied because the payments had no necessary connection with the petitioner's individual business. They arose independently of, and were not current operating expenses incident to, the normal conduct of his business. Cf. *Simmons Co.* v. *Commissioner*, 33 F. (2d) 75 (C.C.A. 1st), certiorari denied, 280 U.S. 588. As we are dealing with the right to a deduction, petitioner must bring himself clearly within the statute.

Since such cases as the instant one necessarily depend upon their particular facts, there is no rule of universal application which is controlling. However, the result below seems to be sustained by decisions in closely analogous cases. In *White* v. *Commissioner*, 61 F. (2d) 726 (C.C.A. 9th), a partnership sought to deduct payments made in settlement of a separate individual debt of one of its members. It was claimed that the amount paid was deductible as an ordinary and necessary expense on the ground that

it was necessary to avoid a lawsuit by the creditor bank, thus protecting the credit of the partnership. The court held that, while it might be expedient to pay the obligation of a partner incurred in a former business venture, it did not follow that the amount paid was deductible as an ordinary and necessary expense of the partnership. The court said (p. 729):

> It certainly cannot be said that the payments involved were ordinary expenses, nor have the petitioners sustained the burden of showing them to be necessary. It is conceded by the parties that White had a valid legal defense to an action instituted against him by the bank and that there was no liability of the new partnership to the bank for this indebtedness.

The voluntary assumption of another's obligation is not an ordinary and necessary business expense within the meaning of the Revenue Acts. *Robinson* v. *Commissioner*, 53 F. (2d) 810 (C.C.A. 8th); *National Piano Mfg. Co.* v. *Burnet*, 50 F. (2d) 310 (App.D.C.). See *Mastin* v. *Commissioner*, 28 F. (2d) 748 (C.C.A. 8th); *Stephenson* v. *Commissioner*, 43 F. (2d) 348 (C.C.A. 8th). The court said in the *National Piano case* that the payment by one corporation of another's Federal income tax, if voluntary, would not be a necessary expense.

The regulations of the Treasury Department under the Revenue Acts of 1924, 1926, and 1928 (*infra*, pp. 9–10) limit deductions, under the provision for "ordinary and necessary expenses" in carrying on a "trade or business", to the current operating expenses incurred in producing the income. This long-con-

tinued administrative construction, accompanied by repeated reenactment of the statutory provisions under which it was adopted, constitutes an approval and adoption of the construction. See *Burnet* v. *Guggenheim*, No. 283, October Term, 1932, decided February 6, 1933; *Massachusetts Mutual Life Insurance Co.* v. *United States*, No. 322, October Term, 1932, decided February 6, 1933.

The petitioner asserts that the present case cannot be reconciled with *A. Harris & Co.* v. *Lucas*, 48 F. (2d) 187 (C.C.A. 5th). In that case a department store, which had been discharged from its debts in a compromise settlement, found that its borrowing power had been seriously impaired, and, in order to reestablish its credit, paid its former creditors the balance of the debts due them. The court pointed out that the question in such cases depends upon the peculiar facts and decided that such payments in the case of the taxpayer involved were necessary to preserve and continue its business and hence were allowable as deductions. The two cases are distinguishable. In the *A. Harris & Co. case* the payments were made by the party which had incurred the claims paid. In the instant case the payments were made by one who never had been liable for the debt and there was no such intimate relationship between petitioner's business and the payments made here as there was in the *Harris case*, where the payment was necessary to obtain credit for the same enterprise which had previously proved to be an unsafe credit risk.

The statement in the *A. Harris & Co. case*, to the effect that the statute is not to be construed as requiring a deductible expense to be both ordinary and necessary, is contrary to the weight of authority. *Hubinger* v. *Commissioner*, 36 F. (2d) 724 (C.C.A. 2d), certiorari denied *sub nom. New Haven Bank* v. *Lucas*, 281 U.S. 741; *Lloyd* v. *Commissioner*, *supra*; *Parkersburg Iron & Steel Co.* v. *Burnet*, 48 F. (2d) 163 (C.C.A. 4th); *White* v. *Commissioner*, *supra*. That statement was not necessary to the conclusion reached in view of the fact that the court classified the payments as advertising expenses, and as such they were clearly both ordinary and necessary.

The other cases cited by the petitioner appear to be so clearly distinguishable as not to require separate analysis.

CONCLUSION

The decision below was correct and does not seem to conflict with the decisions of other Federal courts. The case turns upon its particular facts. The petition should be denied.

Respectfully submitted.

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Attorney.

May, 1933

APPENDIX

Revenue Act of 1924, c. 234, 43 Stat. 253, 269:

SEC. 214. (a) In computing net income there shall be allowed as deductions:

(1) All the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business, including a reasonable allowance for salaries or other compensation for personal services actually rendered; traveling expenses (including the entire amount expended for meals and lodging) while away from home in the pursuit of a trade or business; and rentals or other payments required to be made as a condition to the continued use or possession, for purposes of the trade or business, of property to which the taxpayer has not taken or is not taking title or in which he has no equity. (U.S.C., Title 26, Sec. 955.)

Section 214 (a) (1) (U.S.C.App., Title 26, Sec. 955) and Section 215 (a) (2) and (3) (U.S.C.App., Title 26, Sec. 956) of the Revenue Act of 1926, c. 27, 44 Stat. 9, 26, 28, and Section 23 (a) of the Revenue Act of 1928, c. 852, 45 Stat. 791, 799, are identical.

Treasury Regulations 65, promulgated under the Revenue Act of 1924:

ART 24. *Methods of accounting.*— * * *

(2) Expenditures made during the year should be properly classified as between capital and income; that is to say, expenditures for items of plant, equipment, etc., which have a useful life extending substantially beyond the year should be charged to a capital account and not to an expense account; * * *.

ART. 101. *Business expenses.*—Business expenses deductible from gross income include the ordinary and necessary expenditures directly connected with or pertaining to the taxpayer's trade or business, except the classes

of items which are deductible under the provisions of articles 121–251. * * * Among the items included in business expenses are management expenses, commissions, labor, supplies, incidental repairs, operating expenses of automobiles used in the trade or business, traveling expenses while away from home solely in the pursuit of a trade or business (see article 102), advertising and other selling expenses, together with insurance premiums against fire, storm, theft, accident, or other similar losses in the case of a business, and rental for the use of business property. But see article 293. * * *

ART. 112. *When charges deductible.*—Each year's return, so far as practicable, both as to gross income and deductions therefrom, should be complete in itself, and taxpayers are expected to make every reasonable effort to ascertain the facts necessary to make a correct return. See articles 21–24 and 50. The expenses, liabilities, or deficit of one year cannot be used to reduce the income of a subsequent year. But see section 206 and articles 1621–1626. A taxpayer has the right to deduct all authorized allowances, and it follows that if he does not within any year deduct certain of his expenses, losses, interest, taxes, or other charges, he can not deduct them from the income of the next or any succeeding year. It is recognized, however, that particularly in a going business of any magnitude there are certain overlapping items both of income and deduction, and so long as these overlapping items do not materially distort the income they may be included in the year in which the taxpayer, pursuant to a consistent policy, takes them into his accounts. * * *

The pertinent regulations under the 1926 and 1928 Acts are to the same effect.

U. S. GOVERNMENT PRINTING OFFICE: 1933

INDEX

	Page
Opinions below	1
Jurisdiction	1
Question presented	2
Statutes and regulations involved	2
Statement	2
Summary of argument	4
Argument	5
Conclusion	13
Appendix	14–16

CITATIONS

Cases:

American Rolling Mill Co. v. *Commissioner*, 41 F. (2d) 314	12
Blackwell Oil & Gas Co. v. *United States*, 60 F. (2d) 257	6
Burnet v. *Guggenheim*, 288 U.S. 280	8
Burroughs Bldg. Material Co. v. *Commissioner*, 47 F. (2d) 178	13
Central Trust Co. v. *Howard*, 275 Mass. 153	12
Colony Coal & Coke Corp. v. *Commissioner*, 52 F. (2d) 923	10
Commissioner v. *Field*, 42 F. (2d) 820	13
Commissioner v. *Peoples Pittsburg Trust Co.*, 60 F. (2d) 187	11
Corning Glass Works v. *Lucas*, 37 F. (2d) 798, certiorari denied, 281 U.S. 742	12
Ellis v. *Burhet*, 50 F. (2d) 343	10
First Nat. Bank of Omaha v. *Commissioner*, 49 F. (2d) 70	8
Great Northern Ry. Co. v. *Commissioner*, 40 F. (2d) 372, certiorari denied, 282 U.S. 855	9
Hammond-Knowlton, Admx. v. *Commissioner*, 19 B.T.A. 947	9
Harris, A., & Co. v. *Lucas*, 48 F. (2d) 187	9, 12
Hubinger v. *Commissioner*, 36 F. (2d) 724, certiorari denied, 281 U.S. 741	12
Kenan v. *Bowers*, 50 F. (2d) 112	8
Kornhauser v. *United States*, 276 U.S. 145	10
Lloyd v. *Commissioner*, 55 F. (2d) 842	8, 10, 12
Louden Machinery Co. v. *United States*, 57 F. (2d) 911	6
Massachusetts Mutual Life Ins. Co. v. *United States*, 288 U.S. 269	8
Mastin v. *Commissioner*, 28 F. (2d) 748	7
National Piano Mfg. Co. v. *Burnet*, 50 F. (2d) 310	7
Newark Milk & Cream Co. v. *Commissioner*, 34 F. (2d) 854	7
Old Colony R.R. Co. v. *Commissioner*, 284 U.S. 552	5

Cases—Continued	Page
One Hundred Five West Fifty-fifth St. v. *Commissioner*, 42 F. (2d) 849	7
Parkersburg Iron & Steel Co. v. *Burnet*, 48 F. (2d) 163	12
Robinson v. *Commissioner*, 53 F. (2d) 810	7
Simmons Co. v. *Commissioner*, 33 F. (2d) 75, certiorari denied, 280 U.S. 588	8
Spring Canyon Coal Co. v. *Commissioner*, 43 F. (2d) 78, certiorari denied, 284 U.S. 654	8
Stephenson v. *Commissioner*, 48 F. (2d) 848	7
Tunnel R.R. of St. Louis v. *Commissioner*, 61 F. (2d) 166, certiorari denied, 288 U.S. 604	13
Union Insurance Co. v. *United States*, 73 U.S. 759	12
United States v. *Fisk*, 70 U.S. 445	12
White v. *Commissioner*, 61 F. (2d) 726	7, 10, 12
Williams v. *Burnet*, 59 F. (2d) 357	8
Woolford Realty Co. v. *Rose*, 286 U.S. 319	6
Statutes:	
Revenue Act of 1924, c. 234, 43 Stat. 253, Sec. 214 (U.S.C., Title 26, Sec. 955)	14
Revenue Act of 1926, c. 27, 44 Stat. 9:	
Sec. 214 (U.S.C.App., Title 26, Sec. 955)	14
Sec. 215 (U.S.C.App., Title 26, Sec. 956)	14
Revenue Act of 1928, c. 852, Sec. 23, 45 Stat. 791	14
Miscellaneous:	
Endlich's *Interpretations of Statutes*, Section 305	13
Treasury Regulations 65, promulgated under the Revenue Act of 1924:	
Art. 101	14
Art. 292	15

In the Supreme Court of the United States

OCTOBER TERM, 1933

No. 33

THOMAS H. WELCH, PETITIONER

v.

GUY T. HELVERING, COMMISSIONER OF INTERNAL REVENUE

ON WRIT OF CERTIORARI TO THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE EIGHTH CIRCUIT

BRIEF FOR THE RESPONDENT

OPINIONS BELOW

The opinion of the Board of Tax Appeals (R 23–24) is reported in 25 B.T.A. 117. The opinion of the Circuit Court of Appeals (R. 38–40) is reported in 63 F. (2d) 976.

JURISDICTION

The judgment of the Circuit Court of Appeals was entered March 24, 1933. (R. 40–41.) The petition for writ of certiorari was filed April 24, 1933, and was granted May 22, 1933. The jurisdiction of this Court is invoked under Section 240 (a) of the Judicial Code, as amended by the Act of February 13, 1925.

QUESTION PRESENTED

Whether petitioner may deduct as an ordinary and necessary expense in carrying on his individual business amounts voluntarily paid to the creditors of a bankrupt corporation with which he had been associated.

STATUTES AND REGULATIONS INVOLVED

The applicable provisions of the statutes and regulations are set forth in the Appendix, pp. 14–16, *infra*.

STATEMENT

The following is a summary of the facts found by the Board of Tax Appeals (R. 22–23):

During 1922 the petitioner was secretary of the E. L. Welch Company, a Minnesota corporation, engaged in the grain business. Except for ten shares of stock owned by him, all the stock of the E. L. Welch Company was owned by petitioner's father. For several years prior to 1922 taxpayer had been in close touch with the customers of E. L. Welch Company, having traveled through the territory in which it did business during three or four months each summer making and dealing with present and prospective customers. He took charge of all grain as it came into Minneapolis and attended to its grading and sale. His father looked after the financial end of the business only.

On March 23, 1922, the E. L. Welch Company was adjudged an involuntary bankrupt, and the petitioner was adjudged a voluntary bankrupt on

August 5, 1922. Both the company and he were discharged from liability for debts. Shortly thereafter the petitioner entered into a contract with the Kellogg Company to purchase grain for it on a commission basis. In order to reestablish his standing and credit and to revive new business contacts with former customers of the E. L. Welch Company, the petitioner decided to reimburse certain creditors of the E. L. Welch Company as far as he was able. Beginning in 1924, he made small payments to all of the numerous creditors, except two, by a special check which bore the following indorsement:

> The payee of this check, by the endorsement hereof, accepts and agrees to apply the same on its claim against E. L. Welch Company, according to the terms of the letter of transmittal. It has nothing to do with present or future business relations with the maker of the check and is not to be considered as acknowledging any existing claim or renewing any barred claim against him.

From 1924 to 1928 petitioner earned commissions and made payments to reimburse creditors of the E. L. Welch Company as follows:

Year	Commissions	Credits of E. L. Welch Co.
1924	$18,028.20	$3,975.97
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1928	26,177.56	11,068.25

On his income-tax returns for 1924, 1925, and 1926 petitioner reported only the amount remaining from commissions earned after payments of the above amounts to creditors of the E. L. Welch Company. On his income-tax returns for 1927 and 1928 he reported the total commissions received and deducted the payments to creditors of the E. L. Welch Company.

The Commissioner added the payments for 1924, 1925, and 1926 to petitioner's income and disallowed the deductions taken in 1927 and 1928. The Board of Tax Appeals sustained this action (R. 24–25), and upon appeal the Circuit Court of Appeals affirmed (R. 40–41).

SUMMARY OF ARGUMENT

The words of the statute taken in their ordinary meaning preclude the allowance of the payments here involved as ordinary and necessary business expenses. The assumption of corporate debts by a stockholder is not ordinarily an expense of the stockholder's business, and clearly the expense was not necessary but voluntary and gratuitous. The deductions claimed must be denied because the payments had no necessary connection with the petitioner's individual business and were not current operating expenses incident to the normal conduct of his business. Admittedly the payments had some effect upon his business, but they were too indirect to justify the deduction under the statute.

One purpose of the payments was to build up the business. The resulting benefit extended substantially beyond the year of payment. Payments made for such a purpose must be regarded as closely analogous to capital expenditures, which are not allowable as deductions.

The use of the coordinate conjunction requires, in the absence of a different legislative intent, that an expense be both ordinary and necessary to be deductible.

ARGUMENT

During the years in controversy the petitioner was engaged in the business of purchasing grain on a commission basis for the Kellogg Company. From the gross income of his business he seeks to deduct as an ordinary and necessary business expense amounts paid to the creditors of the E. L. Welch Company, a bankrupt corporation, with which he was formerly connected as an officer and a stockholder. It is submitted that these payments do not come within the terms of Section 214 (a) (1) of the Revenue Act of 1924 and the similar provisions of the 1926 and 1928 Acts (*infra*, p. 14), which allow the deduction of "all the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business * * *."

The payments were unusual and gratuitous rather than ordinary and necessary. The words in the statute must be presumed to be used in their ordinary meaning. *Old Colony R.R. Co.* v. *Com-*

missioner, 284 U.S. 552; *Woolford Realty Co.* v. *Rose,* 286 U.S. 319, 327. *Ordinary* is defined as common, usual, often recurring. The word *necessary* is susceptible of conveying various shades of meaning and is used at times as a synonym for essential, indispensable, requisite, inevitable, and at other times for expedient, appropriate, needful, incidental, convenient. In individual cases the courts have adopted the meaning which most clearly reflects the intention of the legislature.

It is submitted that it is not common, usual, often recurring, for a minority stockholder owning only a small fraction of the capital stock to pay the discharged debts of a bankrupt corporation. The assumption of corporate losses by a stockholder is not ordinarily an expense in the stockholder's individual business in view of the separate taxable identities of a corporation and an individual. Nor was the expense *necessary* in the sense that it was essential, needful, requisite, or indispensable. The claims upon which the payments were made were not the obligations of the petitioner. The debts were not the debts of the taxpayer's business, and their payment was voluntary and gratuitous and therefore not deductible. *Louden Machinery Co.* v. *United States,* 57 F. (2d) 911 (C.Cls.). In *Blackwell Oil & Gas Co.* v. *United States,* 60 F. (2d) 257 (C.C.A. 10th), the corporation assumed all costs and expenses of a suit brought against ten of its principal stockholders. The suit was compromised, and the corporation claimed the amount

paid as a deduction. The court said that the amount paid was not the debt of the corporation, was voluntarily paid, and under no circumstances was it allowable under the statute. Likewise a gratuitous payment by a corporation to settle a dispute between its stockholders was not allowed. *One Hundred Five West Fifty-fifth St.* v. *Commissioner,* 42 F. (2d) 849 (C.C.A. 2d). To the same effect *Robinson* v. *Commissioner,* 53 F. (2d) 810 (C.C.A. 8th), involving taxes paid on another's property, also *White* v. *Commissioner,* 61 F. (2d) 726 (C.C.A. 9th), involving payments made by a partnership in settlement of a separate individual debt of one of its members. See also *National Piano Mfg. Co.* v. *Burnet,* 50 F. (2d) 310 (App.D.C.); *Mastin* v. *Commissioner,* 28 F. (2d) 748 (C.C.A. 8th); *Stephenson* v. *Commissioner,* 43 F. (2d) 348 (C.C.A. 8th).

It has been held that an expenditure made because it was considered expedient or convenient does not satisfy the statute. *White* v. *Commissioner, supra.* An amount paid by a corporation under an agreement whereby former stockholders discontinued litigation and the remaining stockholders obtained control was held not deductible as a business expense, although the corporation benefited through the termination of litigation which was harming it. *Newark Milk & Cream Co.* v. *Commissioner,* 34 F. (2d) 854 (C.C.A. 3d). A bank taking over the assets and liabilities of another bank was not entitled to deduct from income

a bonus paid for the purpose of securing a favorable contact with the depositors of the liquidating bank. *First Nat. Bank of Omaha* v. *Commissioner,* 49 F. (2d) 70 (C.C.A. 8th).

The regulations of the Treasury Department under the Revenue Acts of 1924, 1926, and 1928 (*infra,* p. 14), have consistently construed the provision allowing the deductions for business expense as including the ordinary and necessary expenditures directly connected with or pertaining to the taxpayer's trade or business. Among these items are management expenses, commissions, labor, advertising, insurance, and rents. Expenses of this character are current operating expenses. *Williams* v. *Burnet,* 59 F. (2d) 357 (App.D.C.); *Simmons Co.* v. *Commissioner,* 33 F. (2d) 75 (C.C.A. 1st), certiorari denied, 280 U.S. 588. Further support is found in the fact that this long-continued administrative construction, accompanied by repeated reenactment of the statutory provision under which it was adopted, constitutes an approval and adoption of the construction. *Burnet* v. *Guggenheim,* 288 U.S. 280; *Massachusetts Mutual Life Ins. Co.* v. *United States,* 288 U.S. 269.

Only such deductions as are authorized by the statute are permitted. *Spring Canyon Coal Co.* v. *Commissioner,* 43 F. (2d) 78 (C.C.A. 10th), certiorari denied, 284 U.S. 654; *Lloyd* v. *Commissioner,* 55 F. (2d) 842 (C.C.A. 7th); *Kenan v. Bowers,* 50 F. (2d) 112 (C.C.A. 2d). Deductions are a matter of legislative grace and petitioner must

bring himself clearly within the statute. It is submitted that since the claims upon which the payments were made were not the obligations of the petitioner and did not directly arise out of the normal conduct of his business, the deductions do not come clearly within the statute and must be disallowed.

If the payments made by petitioner do not meet the requirement of being "ordinary and necessary" expenses of the taxable year in carrying on a business, it is unnecessary to inquire further in an attempt to classify them. See *Great Northern Ry. Co.* v. *Commissioner,* 40 F. (2) 372 (C.C.A. 8th), certiorari denied, 282 U.S. 855; *Isabelle Hammond-Knowlton, Administratrix,* v. *Commissioner,* 19 B.T.A. 947. But if they are capital expenditures they are necessarily not within the class of current business expenses. If these payments may be regarded as being connected with petitioner's business, we believe they are essentially capital expenditures.

The Board found that the payments in question were made "to reestablish his standing and credit and to revive new business contacts with former customers of the E. L. Welch Company." (R. 22.) The taxpayer testified that his purpose was to "reestablish my business" (R. 34), and that he built up a large business because he acted square with the creditors (R. 33). Even though expenditures for the purpose of reestablishing his credit may be deductible (*A. Harris & Co.* v. *Lucas,* 48 F. (2d) 187

(C.C.A. 5th)), there would seem to be no doubt that expenditures for the purpose of building up a business are in the nature of a capital expenditure, since a continuing benefit inures to the taxpayer throughout future years. The taxpayer testified that as a result of these payments he was then, at the time of the Board hearing, doing business with a number of former customers of the corporation. (R. 33.) Thus because of payments made as early as 1924 he was enabled to secure business in 1931. Public favor and the possibility of future patronage constitute goodwill which is a capital asset. *Colony Coal & Coke Corp.* v. *Commissioner,* 52 F. (2d) 923 (C.C.A. 4th). Expenditures made to acquire an asset are not deductible. Regulations 65, Art. 292, *infra.*

The petitioner contends that the expenditures were ordinary and necessary because they were made in order to reestablish his standing and credit and to build up his business. Payments made for such a purpose cannot be said to arise directly out of the conduct of one's business; and while they may have some incidental effect upon his business, the relationship between them and the business is too indirect to justify the deduction. *White* v. *Commissioner, supra.* Plainly they fall short of being current operating expenses incident to the normal conduct of the business. *Lloyd* v. *Commissioner, supra; Ellis* v. *Barnet,* 50 F. (2d) 343 (App. D.C.).

The case of *Kornhauser* v. *United States*, 276 U.S. 145, involved the deductibility of attorneys' fees paid to retain earnings of the taxpayer's business. The case turned upon the question whether the fees represented a business or a personal expense, and it was held that the expense of retaining business income was directly connected with the operation of the taxpayer's business. The expenditures of the instant case can be allowed only on the theory that they were directly connected with the earnings of his business. It is submitted that payments made to enhance one's financial standing or to secure lasting benefits are too indirectly connected with the current operations of a business to fall within the statute.

The case of *Commissioner* v. *Peoples Pittsburg Trust Co.*, 60 F. (2d) 187 (C.C.A. 3d), is not in point. The taxpayer as part of his regular duties as an officer of the corporation executed the tax returns for the corporation. He and another were indicted for conspiracy to defraud the United States by means of false and fraudulent returns but were subsequently acquitted. The court stressed the consideration that the taxpayer's business was that of being a corporate officer performing duties devolving upon him as an executive head of the corporation and that the expense of defending the charge was deemed necessary to remove a criminal quality attributed to acts performed by him in carrying out his trade or business. The direct relationship between the expense and the business is reasonably apparent.

For the same reason the case of *American Rolling Mill Co.* v. *Commissioner,* 41 F. (2d) 314 (C.C.A. 6th), is also distinguishable. Contributions to a civic improvement fund were found to be reasonably incidental to the business of the company, which employed a large part of the city's population. The case of *Corning Glass Works* v. *Lucas,* 37 F. (2d) 798 (App.D.C.), certiorari denied, 281 U.S. 742, is distinguishable for the same reason as are the Board cases cited by the petitioner.

The statement in the *A. Harris & Co. case, supra,* to the effect that the statute is not to be construed as requiring a deductible expense to be both ordinary and necessary is contrary to the weight of authority. *Hubinger* v. *Commissioner,* 36 F. (2d) 724 (C.C.A. 2d), certiorari denied, *sub nom. New Haven Bank* v. *Lucas,* 281 U.S. 741; *Lloyd* v. *Commissioner, supra; White* v. *Commissioner, supra; Parkersburg Iron & Steel Co.* v. *Burnet,* 48 F. (2d) 163 (C.C.A. 4th). The word *and* is a coordinate conjunction expressing the relation of addition. The word *or* is a disjunctive particle in its accurate use and marks an alternative. *Central Trust Co.* v. *Howard,* 275 Mass. 153. While the courts are often compelled to construe *and* as meaning *or* and again *or* as meaning *and* to give effect to the clear intention of the legislature (*United States* v. *Fisk,* 70 U.S. 445; *Union Insurance Co.* v. *United States,* 73 U.S. 759), neither *and* or *or* may be interchanged when the meaning of the lan-

guage used in the statute is plain and there is nothing in it to call for such substitution. Endlich's *Interpretations of Statutes,* Section 305. The reason given by the court in the *Harris case* does not warrant the substitution there made, for it does not appear correct to say that an expenditure is allowable if it is not a capital expenditure. *Commissioner* v. *Field,* 42 F. (2d) 820 (C.C.A. 2d); *Tunnel R.R. of St. Louis* v. *Commissioner,* 61 F. (2d) 166 (C.C.A. 8th), certiorari denied, 288 U.S. 604; *Burroughs Bldg. Material Co.* v. *Commissioner,* 47 F. (2d) 178 (C.C.A. 2d). Furthermore, the regulations have construed *and* in its cumulative sense, and repeated reenactments of the statute have not disturbed this construction.

CONCLUSION

We submit that the decision below is correct and should be affirmed.

J. CRAWFORD BIGGS,
Solicitor General.
SEWALL KEY,
JOHN G. REMEY,
Special Assistants to the Attorney General.

SEPTEMBER, 1933.

APPENDIX

Revenue Act of 1924, c. 234, 43 Stat. 253, 269:

> SEC. 214. (a) In computing net income there shall be allowed as deductions:
>
> (1) All the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business, including a reasonable allowance for salaries or other compensation for personal services actually rendered; traveling expenses (including the entire amount expended for meals and lodging) while away from home in the pursuit of a trade or business; and rentals or other payments required to be made as a condition to the continued use or possession, for purposes of the trade or business, of property to which the taxpayer has not taken or is not taking title or in which he has no equity. (U.S.C., Title 26, Sec. 955.)

Section 214 (a) (1) (U.S.C.App., Title 26, Sec. 955) and Section 215 (a) (2) and (3) (U.S.C.App., Title 26, Sec. 956) of the Revenue Act of 1926, c. 27, 44 Stat. 9, 26, 28, and Section 23 (a) of the Revenue Act of 1928, c. 852, 45 Stat. 791, 799, are identical.

Treasury Regulations 65, promulgated under the Revenue Act of 1924:

> ART. 101. *Business expenses.*—Business expenses deductible from gross income include the ordinary and necessary expenditures directly connected with or pertaining

to the taxpayer's trade or business, except the classes of items which are deductible under the provisions of articles 121–251. * * * Among the items included in business expenses are management expenses, commissions, labor, supplies, incidental repairs, operating expenses of automobiles used in the trade or business, traveling expenses while away from home solely in the pursuit of a trade or business (see article 102), advertising and other selling expenses, together with insurance premiums against fire, storm, theft, accident, or other similar losses in the case of a business, and rental for the use of business property. But see article 293. * * *

ART. 292. *Capital expenditures.*—Amounts paid for increasing the capital value or for making good the depreciation (for which a deduction has been made) of property are not deductible from gross income. See section 214 (a) (8) of the statute and article 161. Amounts expended for securing a copyright and plates, which remain the property of the person making the payments, are investments of capital. The cost of defending or perfecting title to property constitutes a part of the cost of the property and is not a deductible expense. The amount expended for architect's services is part of the cost of the building. Commissions paid in purchasing securities are a part of the cost price of such securities. Commissions paid in selling securities are an offset against the selling price. Expenses of the administration of an estate, such as court costs, attorney's fees, and executor's commissions, are chargeable against the corpus of the estate and are not allowable deductions.

Amounts to be assessed and paid under an agreement between bondholders or stockholders of a corporation, to be used in a reorganization of the corporation, are investments of capital and not deductible for any purpose in returns of income. See article 543. An assessment paid by a stockholder of a national bank on account of his statutory liability is ordinarily not deductible but, subject to the provisions of the statute, may in certain cases represent a loss. As to items not deductible by corporations, see section 235 and articles 581 and 582.

The pertinent regulations under the 1926 and 1928 Acts are to the same effect.

U.S. GOVERNMENT PRINTING OFFICE: 1929

SUPREME COURT OF THE UNITED STATES.

No. 33.—October Term, 1933.

Thomas H. Welch, Petitioner, vs. Guy T. Helvering, Commissioner of Internal Revenue, Respondent. | On Writ of Certiorari to the Circuit Court of Appeals for the Eighth Circuit.

[November 6, 1933.]

Mr. Justice Cardozo delivered the opinion of the Court.

The question to be determined is whether payments by a taxpayer, who is in business as a commission agent, are allowable deductions in the computation of his income if made to the creditors of a bankrupt corporation in an endeavor to strengthen his own standing and credit.

In 1922 petitioner was the secretary of the E. L. Welch Company, a Minnesota corporation, engaged in the grain business. The company was adjudged an involuntary bankrupt, and had a discharge from its debts. Thereafter the petitioner made a contract with the Kellogg Company to purchase grain for it on a commission. In order to reëstablish his relations with customers whom he had known when acting for the Welch Company and to solidify his credit and standing, he decided to pay the debts of the Welch business so far as he was able. In fulfilment of that resolve, he made payments of substantial amounts during five successive years. In 1924, the commissions were $18,028.20; the payments $3,975.97; in 1923, the commissions $31,377.07; the payments $11,968.20; in 1926, the commissions $20,925.25, the payments $12,815.72; in 1927, the commissions $22,119.61, the payments $7,379.72; and in 1928, the commissions $26,177.56, the payments $11,068.25. The Commissioner ruled that these payments were not deductible from income as ordinary and necessary expenses, but were rather in the nature of capital expenditures, an outlay for the development of reputation and good will. The Board of Tax Appeals sustained the action of the Commissioner (25 B. T. A. 117), and the Court

of Appeals for the Eighth Circuit affirmed. 63 F. (2d) 976. The case is here on certiorari.

"In computing net income there shall be allowed as deductions . . . . all the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business." Revenue Act of 1924, c. 234; 43 Stat. 253, 269, § 214; 26 U. S. C. § 955; Revenue Act of 1926, c. 27; 44 Stat. 9, 26, § 214; 26 U. S. C. App. § 955; Revenue Act of 1928, c. 852; 45 Stat. 791, 799, § 23; cf. Treasury Regulations 65, Arts. 101, 292, under the Revenue Act of 1924, and similar regulations under the Acts of 1926 and 1928.

We may assume that the payments to creditors of the Welch Company were necessary for the development of the petitioner's business, at least in the sense that they were appropriate and helpful. *McCulloch* v. *Maryland*, 4 Wheat. 316. He certainly thought they were, and we should be slow to override his judgment. But the problem is not solved when the payments are characterized as necessary. Many necessary payments are charges upon capital. There is need to determine whether they are both necessary and ordinary. Now, what is ordinary, though there must always be a strain of constancy within it, is none the less a variable affected by time and place and circumstance. Ordinary in this context does not mean that the payments must be habitual or normal in the sense that the same taxpayer will have to make them often. A lawsuit affecting the safety of a business may happen once in a lifetime. The counsel fees may be so heavy that repetition is unlikely. None the less, the expense is an ordinary one because we know from experience that payments for such a purpose, whether the amount is large or small, are the common and accepted means of defense against attack. Cf. *Kornhauser* v. *United States*, 276 U. S. 145. The situation is unique in the life of the individual affected, but not in the life of the group, the community, of which he is a part. At such times there are norms of conduct that help to stabilize our judgment, and make it certain and objective. The instance is not erratic, but is brought within a known type.

The line of demarcation is now visible between the case that is here and the one supposed for illustration. We try to classify this act as ordinary or the opposite, and the norms of conduct fail us. No longer can we have recourse to any fund of business experience, to any known business practice. Men do at times pay

the debts of others without legal obligation or the lighter obligation imposed by the usages of trade or by neighborly amenities, but they do not do so ordinarily, not even though the result might be to heighten their reputation for generosity and opulence. Indeed, if language is to be read in its natural and common meaning (*Old Colony R. R. Co.* v. *Commissioner*, 284 U. S. 552, 560; *Woolford Realty Co.* v. *Rose*, 286 U. S. 319, 327), we should have to say that payment in such circumstances, instead of being ordinary is in a high degree extraordinary. There is nothing ordinary in the stimulus evoking it, and none in the response. Here, indeed, as so often in other branches of the law, the decisive distinctions are those of degree and not of kind. One struggles in vain for any verbal formula that will supply a ready touchstone. The standard set up by the statute is not a rule of law; it is rather a way of life. Life in all its fullness must supply the answer to the riddle.

The Commissioner of Internal Revenue resorted to that standard in assessing the petitioner's income, and found that the payments in controversy came closer to capital outlays than to ordinary and necessary expenses in the operation of a business. His ruling has the support of a presumption of correctness, and the petitioner has the burden of proving it to be wrong. *Wickwire* v. *Reinecke*, 275 U. S. 101; *Jones* v. *Commissioner*, 38 F. (2d) 550, 552. Unless we can say from facts within our knowledge that these are ordinary and necessary expenses according to the ways of conduct and the forms of speech prevailing in the business world, the tax must be confirmed. But nothing told us by this record or within the sphere of our judicial notice permits us to give that extension to what is ordinary and necessary. Indeed, to do so would open the door to many bizarre analogies. One man has a family name that is clouded by thefts committed by an ancestor. To add to his own standing he repays the stolen money, wiping off, it may be, his income for the year. The payments figure in his tax return as ordinary expenses. Another man conceives the notion that he will be able to practice his vocation with greater ease and profit if he has an opportunity to enrich his culture. Forthwith the price of his education becomes an expense of the business, reducing the income subject to taxation. There is little difference between these expenses and those in controversy here. Reputation and learning are akin to capital assets, like the good

will of an old partnership. Cf. *Colony Coal and Coke Corp.* v. *Commissioner*, 52 F. (2d) 923. For many, they are the only tools with which to hew a pathway to success. The money spent in acquiring them is well and wisely spent. It is not an ordinary expense of the operation of a business.

Many cases in the federal courts deal with phases of the problem presented in the case at bar. To attempt to harmonize them would be a futile task. They involve the appreciation of particular situations, at times with border-line conclusions. Typical illustrations are cited in the margin.*

The decree should be

Affirmed.

A true copy.

Test:

Clerk, Supreme Court, U. S.

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*Ordinary expenses: Commissioner *v.* People's-Pittsburgh Trust Co., 60 F. (2d) 187, expenses incurred in the defense of a criminal charge growing out of the business of the taxpayer; American Rolling Mill Co. *v.* Commissioner, 41 F. (2d) 314, contributions to a civic improvement fund by a corporation employing half of the wage earning population of the city, the payments being made, not for charity, but to add to the skill and productivity of the workmen (cf. the decisions collated in 30 Columbia Law Review 1211, 1212, and the distinctions there drawn); Corning Glass Works *v.* Lucas, 37 F. (2d) 798, donations to a hospital by a corporation whose employes with their dependents made up two thirds of the population of the city; Harris *v.* Lucas, 48 F. (2d) 187, payments of debts discharged in bankruptcy, but subject to be revived by force of a new promise. Cf. Lucas *v.* Ox Fibre Brush Co., 281 U. S. 115, where additional compensation, reasonable in amount, was allowed to the officers of a corporation for services previously rendered.

Not ordinary expenses: Hubinger *v.* Commissioner, 36 F. (2d) 724, payments by the taxpayer for the repair of fire damage, such payments being distinguished from those for wear and tear; Lloyd *v.* Commissioner, 55 F. (2d) 842, counsel fees incurred by the taxpayer, the president of a corporation, in prosecuting a slander suit to protect his reputation and that of his business; 105 West 55th Street *v.* Commissioner, 42 F. (2d) 849, and Blackwell Oil & Gas Co. *v.* United States, 60 F. (2d) 257, gratuitous payments to stockholders in settlement of disputes between them, or to assume the expense of a lawsuit in which they had been made defendants; White *v.* Commissioner, 61 F. (2d) 726, payments in settlement of a lawsuit against a member of a partnership, the effect being to enable him to devote his undivided efforts to the partnership business and also to protect its credit.